Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
	)	
1998 Biennial Regulatory Review --	)	
Review of Depreciation Requirements	)	CC Docket No. 98-137
for Incumbent Local Exchange Carriers	)	
	)	
United States Telephone Association's	)	
Petition for Forbearance from Depreciation	)	ASD 98-91
Regulation of Price Cap Local Exchange	)	
Carriers	)	

REPORT AND ORDER IN CC DOCKET NO. 98-137
MEMORANDUM OPINION AND ORDER IN ASD 98-91

Adopted: December 17, 1999 **Released: December 30, 1999**

By the Commission: Commissioner Furchtgott-Roth dissenting and issuing a statement, and Commissioner Powell concurring in the result.

APPENDIX A: Parties Filing Comments and Reply Comments
APPENDIX B: Summary of Existing and Proposed Prescription Lives
APPENDIX C: Final Rules

I. INTRODUCTION

1. In this Order, as part of our 1998 Biennial Regulatory Review under section 11 of the Communications Act of 1934, as amended (the Act),[1] we address proposals set forth in our Notice of Proposed Rulemaking to reform our depreciation prescription process.[2] With this Order, we greatly streamline the depreciation requirements for price cap incumbent local exchange carriers (LECs). We adopt proposals to permit summary filings, eliminate the prescription of depreciation rates for certain incumbent LECs, expand the prescribed range for the digital switching plant account, and eliminate the theoretical reserve study requirement for mid-sized incumbent LECs. These measures will minimize the regulatory burden on incumbent LECs and will provide them with greater flexibility to adjust their depreciation rates while allowing the Commission to maintain adequate oversight in order to promote competition and protect consumers.[3]

2. We also address a petition for forbearance filed by the United States Telephone Association (USTA)[4] pursuant to section 10 of the Act.[5] Although we deny USTA's petition requesting that the Commission forbear from imposing sections 32.2000(g)[6] and 43.43 of the Commission's rules[7] and that it refrain from conducting depreciation prescription proceedings under Section 220(b) of the Act[8] for all price cap incumbent LECs, we establish a waiver process whereby price cap incumbent LECs can obtain substantially the same regulatory relief from depreciation requirements if certain conditions are met. Using the waiver process, rather than forbearance from our rules, will provide carriers the opportunity to free themselves of depreciation regulation while providing safeguards against the adverse effects that unrestricted changes in depreciation rates could have on competition and consumers.

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[1] 47 U.S.C. § 161.

[2] 1998 Biennial Regulatory Review -- Review of Depreciation Requirements for Incumbent Local Exchange Carriers, *Notice of Proposed Rulemaking*, 13 FCC Rcd 20542 (1998) (*Depreciation Notice*). Seventeen parties filed comments and eleven parties filed reply comments in this proceeding. (*See* Appendix A). USTA filed its comments on November 24, 1998, one day after the due date, accompanied by a Motion to Accept Late-Filed Pleading. In the interest of having a complete record, we will grant USTA's motion.

[3] *See* 47 U.S.C. § 220.

[4] Forbearance from Depreciation Regulation of Price Cap Local Exchange Carriers, Petition for Forbearance of the United States Telephone Association (filed September 21, 1998) (USTA petition).

[5] 47 U.S.C. § 160.

[6] 47 C.F.R. § 32.2000(g). The Commission prescribes depreciation accounting practices for incumbent LECs.

[7] 47 C.F.R. § 43.43. This rule details the reporting and data requirements that the carriers must comply with when they want to change their prescribed depreciation rates.

[8] 47 U.S.C. § 220(b).

II. BACKGROUND

3. The Commission prescribes depreciation factors for price cap incumbent LECs whose revenues exceed an indexed revenue threshold, currently set at $112 million in annual revenue.[9] These carriers currently have investments in telephone plant totaling $288 billion and an accumulated depreciation balance totaling $146 billion.[10] Depreciation constitutes 28 percent of incumbent LECs' total operating expenses, and is their largest single expense.[11]

4. Over the years, the Commission has taken steps to streamline the depreciation requirements to keep pace with changes in communications technology and legal requirements. When incumbent LECs were regulated under cost-of-service (or rate-of-return) regulation, regulation and oversight of the depreciation process was a critical function because prices for incumbent LEC services were set based on costs, including depreciation expenses. Under this regulatory scheme, each carrier seeking to change its depreciation rates was required to submit a depreciation rate study that was reviewed both by the Commission staff and the representatives of the state regulatory authorities. This depreciation prescription process required carriers to submit extensive data for each plant category to support the projection life,[12] survivor curve,[13] and future net salvage[14] estimates underlying their proposed depreciation rates. These data requirements often necessitated voluminous submissions, with up to 25 pages of analysis for each of 34 plant categories for each jurisdiction.

5. In 1980, the Commission departed from its previous practice of relying largely on historical experience to project equipment lives and began to rely on analysis of company plans, technological developments, and other future-oriented studies.[15] In 1993, the Commission issued the *Depreciation Simplification Order* that adopted a simplified depreciation prescription

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[9] The revenue threshold is adjusted annually by an index for inflation. *See* Implementation of the Telecommunications Act of 1996: Reform of Filing Requirements and Carrier Classifications, *Order and Notice of Proposed Rulemaking*, 11 FCC Rcd 11716, 11745-47 (1996); Public Notice, Annual Adjustment of Revenue Threshold, DA 99-805 (rel. Apr. 28, 1999). Currently, the Commission prescribes depreciation rates for the following price cap incumbent LECs: Ameritech, Bell Atlantic, Bell South, SBC, US West, Cincinnati Bell, Citizens of New York, Contel of California, Sprint/United SE, GTE North, GTE Midwest, GTE Florida, GTE Hawaii, GTE South, GTE Southwest, and GTE Northwest.

[10] *See* Automated Reporting Management Information System (ARMIS) Report 43-02, Table B-1, 1998. The accumulated depreciation account represents the portion of an asset account that has been charged against revenue through depreciation expense. It is often referred to as the depreciation reserve.

[11] Federal Communications Commission, *Statistics of Communications Common Carriers*, Table 2.9 (Nov. 1998).

[12] A projection life is the average life expectancy of new assets.

[13] The survivor curve is the expected retirement distribution (or survival distribution) of plant in an account over time.

[14] Future net salvage (FNS) is the estimated gross salvage of plant less any estimated cost of removal. Gross salvage is the amount a carrier receives from disposing of retired plant. Cost of removal is the cost the carrier incurs in retiring plant through the removal and disposition of the plant.

[15] Amendment of Part 31 (Uniform System of Accounts for Class A and Class B Telephone Companies), *Report and Order*, 83 FCC 2d 267 (1980). *See also* Report on Telephone Industry Depreciation, Tax and Capital/Expense Policy at p. 8 (April 15, 1987). ("We determined that by paying closer attention to company plans, technological developments, and other future-oriented analyses, more realistic forecasts could be made, and we have since adopted those recommendations.")

process for AT&T and incumbent LECs.[16] With regard to incumbent LECs, that Order provided for the establishment of ranges for the life and salvage factors that carriers could use to compute their depreciation rates.[17] Consequently, incumbent LECs that proposed life and salvage factors within the Commission-approved ranges no longer needed to file detailed cost support for those rates.[18] In contrast, a carrier that chose to propose depreciation factors outside of the ranges would have to provide cost support to justify it. Today, incumbent LECs remain subject to the Commission's rules under Sections 32.2000(g)[19] and 43.43[20] for purposes of establishing depreciation rates; however, the typical carrier's filing requirements have been reduced by 75 percent when its depreciation proposals are within the prescribed ranges.

6. The recent *Depreciation Notice*[21] sought comment on proposals that would further minimize the burden on incumbent LECs in the depreciation prescription process. Below, we address the proposals set forth in the *Depreciation Notice* and take further steps to streamline the depreciation prescription process for incumbent LECs.

III. 1998 BIENNIAL REGULATORY REVIEW: MODIFICATIONS TO EXISTING RULES

7. In the *Depreciation Notice*, we tentatively concluded that, in the event that the Commission continues to set depreciation rates for some carriers, the depreciation prescription requirements for incumbent LECs should be further streamlined by: (1) reducing the supporting documentation required to be filed by carriers selecting depreciation factors from within prescribed ranges; (2) eliminating the need for depreciation prescription orders for carriers that select depreciation factors within the prescribed ranges; (3) expanding the range of lives for digital electronic switching equipment; and (4) eliminating net salvage from the depreciation prescription process. We also sought comment on the conditions under which incumbent LECs could set their own depreciation rates, even in the absence of full competition. We have concluded that we should take the following actions to further simplify our depreciation prescription process.

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16 Simplification of the Depreciation Prescription Process, *Report and Order*, 8 FCC Rcd 8025, 8063 (1993) (*Depreciation Simplification Order*). In 1989 and 1990, we adopted price cap regulations for AT&T (4 FCC Rcd 2873) and incumbent LECs (5 FCC Rcd 6786), respectively. In the *Depreciation Simplification Order*, we concluded that a more simplified depreciation prescription process would benefit price cap LECs, but were unable to conclude that these carriers were in a position that justified a process as flexible and streamlined as the one we adopted for AT&T. (8 FCC Rcd at 8028).

17 *Id. at* 8048. *See also* Simplification of the Depreciation Prescription Process, *Second Report and Order*, 9 FCC Rcd 3206, 3208 (1994); *Third Report and Order*, 10 FCC Rcd 8442, 8444 (1995). AT&T was provided more discretion in selecting life and salvage factors, and reporting requirements were reduced to five pages per account, from the previously required 25 pages per account. Prescription of depreciation rates for AT&T ended in 1995 when AT&T was declared non-dominant.

18 *See* 47 C.F.R. § 43.43(b) and (c). *See also Second Report and Order*, 9 FCC Rcd at 3207. The streamlined procedures adopted in 1993 reduced the analysis required for each plant account to a maximum of five pages.

19 47 C.F.R. § 32.2000(g).

20 47 C.F.R. § 43.43.

21 *See* n. 2, *supra.*

A. Filing Requirements

8. In the *Depreciation Notice*, we sought comment on a proposal that would reduce price cap incumbent LECs' filing requirements to four summary exhibits, and the electronic data files used to generate them, provided carriers select depreciation factors from within the specified ranges for all accounts and certify that their selections are consistent with their operations.[22] The four summary exhibits are a comparison of existing and proposed depreciation rates; a comparison of existing and proposed annual depreciation expenses; a book and theoretical reserve summary; and the underlying depreciation factors.

9. Some incumbent LECs criticize this proposal. They contend that, even if filing requirements were reduced to four summary exhibits, carriers would still be required to prepare all the same studies to support those exhibits.[23] Several non-LEC commenters, on the other hand, express concern that the Commission, in its efforts to simplify its depreciation prescription process, not deprive itself of the information necessary to maintain even a minimal level of oversight of carrier depreciation rates and practices.[24]

10. We conclude that we must balance the carriers' needs for simplification with the needs of this Commission, ratepayers,[25] state regulatory commissions,[26] and competitors for sufficient information to assess claims the incumbent LECs' may make for regulatory relief. As noted, depreciation expense constitutes a large portion of a carrier's expenses and is significant in determining cost recovery.[27] While we believe we can reduce the amount of information a carrier must file, we find certain basic information is still needed to allow us to adequately monitor a carrier's depreciation practices and amounts associated with these practices. The information that carriers will be required to file in the four summary exhibits, along with the underlying data used to generate them, will provide the depreciation factors (*i.e.*, life, salvage, curve shape, depreciation reserve) required to verify the calculation of the carriers' depreciation rates, estimate the changes in annual depreciation expenses, and monitor the adequacy of the depreciation reserve. This information is critical because it provides the minimum amount of data needed to maintain oversight of carriers' depreciation expenses and rates.

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22 *Depreciation Notice,* 13 FCC Rcd at 20548.

23 SBC Comments at 18; USTA Comments, Attachment A at 5. *But see* Sprint Comments at 2. Sprint supports the filing of summary exhibits, but states that only information representing the accumulated depreciation as percent of investment, future net salvage as a percent of investment, and average remaining life should be required.

24 GSA Comments at 5; MCI-WorldCom Comments at 9; Virginia Comments at 3; AT&T Reply at 3.

25 Ad Hoc Comments at 4; GSA Comments at 4. GSA states that, at a minimum, incumbent LECs should be required to include reports on the retirement of plant from each plant account, preferably by vintage.

26 The Virginia PSC supported the proposal to reduce filings, with the condition that carriers should maintain such source data, documents, and studies to support any cost of service, rate-of-return, or rate-setting activities as may become necessary in the future. Virginia PSC Comments at 3. The Florida PSC stated that electronic data files will provide the Commission with the information necessary for the Commission to continue monitoring and reviewing the basic factor ranges and make modifications as warranted. Florida Comments at 4.

27 *See* ¶ 3, *supra.*

11. We conclude that the proposal in the *Depreciation Notice* strikes an appropriate balance. It will minimize the burden on the carriers, since carriers will not be required to prepare extensive supporting documents for public filing, while providing the minimum amount of data needed to maintain oversight of carriers' depreciation expenses and rates. Thus, we will permit carriers that select depreciation factors from within the specified ranges for all accounts, and certify that their selections are consistent with their operations, to file four summary exhibits along with electronic data files used to generate the summary exhibits as described above.[28]

B. Reduction of Need for Prescription Orders

12. In the *Depreciation Notice* we proposed that, if a carrier selects depreciation factors from within the ranges for all of its accounts, the carrier's new depreciation rates could go into effect without a prescription order.[29] AT&T expresses concern about this proposal, stating that the Commission's current prescription procedures provide a valuable public record that avoids the potential for confusion and misunderstandings that may result in the absence of an official and accepted record of the permissible depreciation rates that the incumbent LECs can use.[30] In this Order, we permit carriers to submit streamlined exhibits if they request depreciation factors for all accounts that are within the prescribed ranges.[31] Carriers that request depreciation factors outside the ranges prescribed by the Commission must continue to submit exhibits for each account.[32] In either case, however, the information filed by the incumbent LEC would contain life, salvage, reserve, rate, and expense information, which will be maintained in public files. Also, much of this data will be maintained in the ARMIS database, and therefore, will be readily available to the public via the Internet.[33] We conclude, therefore, that we can eliminate prescriptions in the case where carriers select depreciation factors from within the prescribed ranges for all of its accounts, thereby further reducing the burden on these carriers, and still maintaining an adequate public record that all interested parties will be able to review.

C. Equipment Life Ranges

13. We proposed to expand the range of lives for digital switching equipment from a range of 16 to 18 years to 13 to 18 years.[34] Incumbent LECs uniformly recommend that we adopt an even wider range than we proposed.[35] Some incumbent LECs proposed minimum projection

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28 *See* Appendix C – Final Rules, New Section 43.43(c)(2).

29 *Depreciation Notice,* 13 FCC Rcd at 20549. Under the Commission's current process, a carrier submits depreciation study data underlying its proposed depreciation rates for staff review. After staff review, the carrier formally files for revised depreciation rates and the Commission releases a public notice requesting comments on the proposed depreciation rate changes. After consideration of the record, the Commission issues a 'prescription order' prescribing appropriate depreciation rates for the carrier. This process is followed even if the carrier selects all its factors from within FCC prescribed ranges.

30 AT&T Comments at 4-5.

31 *See* ¶ 11, *supra.*

32 *See* n. 18, *supra.* In these cases, the Commission will review the record and issue a prescription order on the appropriate depreciation rates for the carrier to use.

33 *See e.g.,* Revision of ARMIS USOA Report (FCC Report 43-02) for Tier I Telephone Companies and Annual Report Form M, AAD 92-46, DA 93-360, at ¶ 16 (rel. Mar. 29, 1993). *See also* ARMIS Report 43-02, Table B-7.

34 *Depreciation Notice*, 13 FCC Rcd at 20549.

35 US West Comments at 9-13; Ameritech Comments at 10; Sprint Comments at 6; SBC Comments

lives as short as eight years for digital switching, arguing that technological change, increased competition, and customer demand for new higher bandwidth services are shortening the lives of switches.[36] Based on our review of the record, we are persuaded that the lower limit of the life range for digital switching should be shortened from the current 16-year minimum to 12 years. We find that this reduction is justified by incumbent LEC accounting data that shows an upward trend in retirements of digital switching equipment in recent years.[37] The increasing retirements are due, in part, to the modular nature of modern digital switches, which allows the incumbent LECs to retire portions of a switch on an interim basis as technology improves.

14. Incumbent LECs also advocate shorter minimum lives for accounts other than digital switching. They contend that our currently prescribed lives are too long and prevent them from recovering adequate depreciation.[38] The incumbent LECs further contend that the Commission's ranges for projection lives are historical and backward-looking. Non-LEC commenters respond that the Commission-prescribed lives are appropriate and forward-looking. They note that the Commission has been reforming its depreciation prescription process since 1980, and that those reforms have resulted in an increase in the composite reserve level from 18.7 percent in 1980 to 48.8 percent in 1997.[39] MCI-WorldCom also notes that the incumbent LECs have been adding over $10 billion to their depreciation reserves each year since the Commission's 1993 depreciation simplification reforms took effect in 1994.[40] We agree with MCI-WorldCom, that, except for digital switching equipment, recent carrier accounting data and trends do not support reductions in the prescribed projection life ranges. Specifically, with the exception of digital switching equipment, incumbent LEC retirement rates have either dropped or remained relatively constant in recent years.[41] This certainly has contributed to the substantial increase in reserve levels that MCI-WorldCom cites.

15. Several incumbent LECs contend that we should adopt the projection lives recommended by Technology Futures, Inc. (TFI).[42] TFI develops its analysis by using the Fisher-Pry model to perform a "substitution analysis" to forecast the pattern by which new technology will replace old technology.[43] TFI's projections about replacement of digital switches, copper loop plant, and circuit equipment extend as far out as 2015.[44] The non-LEC commenters dispute

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at iii.

[36] Ameritech Comments at 10; BellSouth Comments at 12.

[37] ARMIS Report 43-02, Table B-1. This range is slightly wider than the 13 to 18 range we proposed in *Depreciation Notice* to reflect recent retirement rates and trends.

[38] US West Comments at 11; BellSouth Comments at 12; SBC Comments at 22.

[39] AT&T Reply at 3; MCI-WorldCom Reply at 7.

[40] MCI-WorldCom Reply, Attachment 1 at p. 4.

[41] ARMIS Report 43-02, Table B-6.

[42] Ameritech Comments at 10; CBT Comments at 7-8; SBC Comments at 21; Sprint Comments at 6. TFI is an economic consulting firm that has analyzed depreciation issues on behalf of the incumbent LECs.

[43] Transforming the Local Exchange Network: Analysis and Forecasts of Technology Change by Lawrence K. Vanston, Ray L. Hodges and Adrian J. Poitras at 29 (2d ed. 1997) (*Second TFI Study*).

[44] TFI projects the following: fiber in the loop will replace copper feeder cable by 2015, *Id.* at 9; fiber will replace copper in 98 percent of all interoffice trunks by 2000, *Id.* at 8; SONET equipment will replace all non-SONET circuit equipment by 2005, *Id.* at 16; and fiber in the loop will replace copper distribution plant by between 2010 and 2015, *Id.* at 10.

the validity of TFI's analysis.[45] In its study, TFI acknowledges the uncertainty that is inherent in predicting plant replacements. First, it notes that it changed its forecasts for the replacement of distribution plant; forecasting slower replacement in the second edition of its report.[46] Second, it acknowledges that a "true consensus has yet to emerge on a single [fiber in the loop] architecture" and acknowledges that continuing changes in technology, costs, regulation, business relationships, market forecasts, and market share assumptions will affect the rate of conversion to the new technology.[47]

16. Given the significant uncertainty that even TFI acknowledges exists in forecasting plant replacement over the next fifteen years, we do not find that the carriers that advocate adoption of TFI's much shorter projection lives have met their burden. Depreciation reserves are at 51 percent, an all-time high, and have increased for each of the past five years.[48] There is no evidence that the large wave of plant replacements forecast by TFI, which should result in increased retirements, has begun or is about to begin. If the carriers do begin to retire plant more rapidly, our depreciation prescription process is flexible enough to allow them shorter lives and faster depreciation.[49] We conclude, therefore, that the TFI study fails to establish convincingly that current projection lives are inadequate.

17. We also disagree with the incumbent LECs' contention that the Commission should conform its depreciation practices to other shorter lives allowed by some state commissions or by the Securities and Exchange Commission.[50] We do not believe that the depreciation actions taken by certain state public service commissions are determinative in our situation. Some state commissions were implementing state laws which required them to deregulate depreciation.[51] Other state commissions have allowed carriers to select shorter depreciation lives as part of a "social contract" that included promises by the carriers not to raise rates for specified periods. Other federal regulatory commissions, like the Securities and Exchange Commission, operate under their own authorizing legislation and have statutory duties that differ from the requirements imposed on us by the Act.[52] We must discharge our responsibilities under the Act, and the actions that other state and regulatory bodies take under their statutes do not compel us to grant shorter lives.

18. The incumbent LECs also contend that they should be granted shorter depreciation projection lives because they face actual and potential competition from

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45 MCI-WorldCom Reply at 8-11; AT&T Reply at 4-6.

46 *Second TFI Study* at 3.

47 *Id.* at 10.

48 ARMIS Report 43-02, Table B-1, 1993-1998.

49 Our rules allow carriers to propose lives outside the ranges we establish. *See* n. 18 and 32, *supra.*

50 SWB Comments at 22; BellSouth Comments at 6.

51 *See e.g.*, Chapter 364.051 of the Florida Statutes (exempts carriers with 100,000 or more access lines from rate of return regulation, existing prices are frozen for a period of years); Texas Utility Code Ann. § 53.056 (a carrier electing price cap regulation "may determine its own depreciation rates and amortizations.")

52 *See* Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78b. Among other responsibilities, this act requires the Securities and Exchange Commission: to protect interstate commerce, the national credit, and the Federal taxing power; to protect and make effective the national banking system and Federal Reserve System; and to insure the maintenance of fair and honest markets in such transactions.

interexchange carriers (IXCs) and competitive LECs, which, because their depreciation is not regulated, are free to adopt shorter projection lives than the incumbent LECs. We find that the incumbent LECs fail to address several important distinctions between themselves and these other carriers. First, because we do not regulate either their depreciation rates or the prices they charge to their customers, neither the IXCs nor the competitive LECs have the ability to seek regulatory relief for expenses caused by changes in depreciation rates. Additionally, the depreciation practices of IXCs and incumbent LECs are not directly comparable because they use different types of switches and cables.[53] Accordingly, nothing has occurred to compel a change to the Commission's previous conclusion that the characteristics of IXCs and incumbent LECs require separate analyses.[54] We conclude, therefore, that incumbent LECs have not sufficiently demonstrated the validity of the assumptions underlying their proposed shorter lives for plant equipment categories other than digital switching equipment.

19. As discussed above, we disagree with the incumbent LECs' contentions that, if we fail to grant USTA's petition for forbearance from depreciation prescription, we should permit them to adopt shorter projection lives for their plant. We conclude instead that the waiver process, discussed below in section G, better balances the desire of carriers for more rapid depreciation with the needs of consumers and competitors for just and reasonable rates.

D. Salvage and Cost of Removal

20. In order to calculate net salvage, carriers must estimate both gross salvage and cost of removal. Given the speculative nature of these estimates and the burdens associated with their calculation, the *Depreciation Notice* tentatively concluded that the prescription of net salvage no longer serves a regulatory purpose and that eliminating that factor from the formula would significantly reduce the regulatory burden of the depreciation prescription process. Accordingly, we proposed to eliminate the future net salvage factor from the depreciation formula and to record net salvage as a current expense in the period incurred. Alternatively, we proposed making the elimination of net salvage from the depreciation formula optional, and allowing each incumbent LEC the option to treat net salvage as either a current expense or a component of depreciation.[55]

21. The Financial Accounting and Standards Board (FASB) is currently conducting a proceeding that could change how firms must account for net salvage on their financial books.[56] BellSouth argues that, if we were to adopt our currently pending proposal, price cap carriers might be required to maintain two inconsistent sets of accounting records for the same salvage

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[53] MCI-WorldCom Reply at 12; GSA Reply at 13.

[54] Simplification of the Depreciation Prescription Process, *Notice of Proposed Rulemaking*, 8 FCC Rcd 146, 148 (1992). The Commission stated that "the underlying conditions that go into estimating the basic factors for interexchange carriers (IXCs) and incumbent LECs are sufficiently different for the two groups that they should be considered differently." In the *Depreciation Simplification Order,* the Commission adopted different depreciation processes for IXCs and incumbent LECs. 8 FCC Rcd at 8062. *See also* AT&T Reply at 7.

[55] *Depreciation Notice*, 13 FCC Rcd at 20551.

[56] Sprint Comments at 9; GSA Reply at 14; BellSouth Comments at Exhibit I.

transactions.[57] In light of the pending action by the FASB, we conclude that it is appropriate to defer action on this issue.[58]

E. Reporting Requirements for Mid-Sized LECs

22. In the *Depreciation Notice*, we proposed that mid-sized incumbent LECs no longer be required to file annual theoretical reserve studies.[59] Because the Commission would continue to receive theoretical reserve studies from the largest incumbent LECs, which serve approximately 90 percent of all access lines, this proposal would relieve these mid-sized companies of this regulatory burden without seriously encumbering the Commission's ability to monitor and evaluate the adequacy of the industry's reserves.[60] Although a carrier's theoretical reserve studies allow us to monitor and evaluate the adequacy of a carrier's depreciation reserve, we recognize the burden these studies impose on mid-sized incumbent LECs.[61] On balance, we believe that the benefits of streamlining depreciation reporting for mid-sized LECs outweighs the risks. We note that, if necessary, we can request a mid-sized carrier to provide a theoretical reserve study.[62] Further, we note that incumbent LECs with individual annual operating revenues below the indexed revenue threshold continue to be exempt from the Commission's depreciation prescription process.

F. Confidentiality

23. The Commission also sought comment on whether the Commission's existing confidentiality procedures, contained in 47 C.F.R. §§ 0.457 and 0.459 of the Commission's rules, are adequate or whether additional safeguards need to be adopted to protect information that carriers regard as confidential. The only parties to comment on this issue agreed that the Commission's existing confidentiality procedures are sufficient.[63] Accordingly, we find no reason to alter the policies we have in place to protect the confidentiality of carrier information.

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57 BellSouth Comments at 14.

58 The Commission requested comment on the proper accounting treatment if net salvage were removed from the depreciation process. In light of our decision to defer action on removing net salvage from the depreciation calculation, the issue of accounting treatment is moot and we need not take action on it at this time. *See Depreciation Notice*, 13 FCC Rcd at 20551.

59 *See Depreciation Notice* at 20552. To avoid unnecessary complexity, we tentatively concluded that we should apply the definition of mid-sized incumbent LECs that had been proposed in the 1998 Biennial Regulatory Review Accounting and Cost Allocation proceeding. We subsequently adopted the proposal in that proceeding. *See* 1998 Biennial Regulatory Review – Review of Accounting and Cost Allocation Requirements, *Report and Order in CC Docket 98-81, Order on Reconsideration in CC Docket No. 96-150, Memorandum Opinion and Order in ASD File No. 98-43*, FCC 99-106 (rel. June 30, 1999). We find that for efficiency and consistency, we will apply the same requirements for determining whether a carrier qualifies as a mid-sized incumbent LEC. Thus, as in the 1998 Biennial Regulatory Review proceeding on accounting and cost allocation, mid-sized incumbent LECs will be defined, for depreciation purposes, based on the aggregate revenues of the incumbent LEC and any LEC that it controls, is controlled by, or is under common control with another LEC. If the aggregate revenues of these affiliated incumbent LECs are less than $7 billion, then each LEC within that group will qualify as a mid-sized incumbent LEC for purposes of our depreciation prescription requirements.

60 *See* 47 C.F.R. § 43.43.

61 *See e.g.*, MCI-WorldCom Comments at 14.

62 *See* 47 U.S.C. §§ 218, 220(c) and 47 C.F.R. § 43.43(c).

63 Ameritech Comments at 14; MCI-WorldCom Comments at 11; AT&T Comments at 4.

G. Waivers

24. In the *Depreciation Notice*, we noted that even under price caps, depreciation had a potentially significant impact on a carrier's price cap indexes and its rates for some non-price cap services.[64] We invited comment on additional ways that we might eliminate our need for depreciation prescription.[65] In addition, the USTA forbearance petition raised issues concerning conditions under which the depreciation process might not be necessary.[66] Incumbent LECs generally claim that the depreciation prescription process should no longer be required and that imposition of such requirements is a deterrent to a competitive market.[67] Some commenters suggest there may be certain conditions that would permit the Commission to allow carriers to set their own depreciation rates. For instance, BellSouth proposes that a carrier be allowed to set its own depreciation rates if the carrier agrees to waive its rights to an automatic low-end adjustment.[68] Other commenters maintain that oversight of the depreciation process is still needed in order to assure the incumbent LECs do not thwart movement to a competitive environment.[69]

25. As discussed below, we believe that it would be appropriate to grant a waiver of our depreciation prescription process for certain price cap incumbent LECs in certain instances.[70] Specifically, we find that such a waiver may be approved when an incumbent LEC, voluntarily, in conjunction with its request for waiver: (1) adjusts the net book costs on its regulatory books to the level currently reflected in its financial books[71] by a below-the-line[72] write-off; (2) uses the same depreciation factors and rates for both regulatory and financial

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64 *Depreciation Notice*, 13 FCC Rcd at 20547. The *Depreciation Notice* requested comment on the significance of depreciation with regard to the low-end adjustment, a recalculation of the productivity factor, an exogenous cost determination, a calculation of the Base Factor Portion, an above-cap filing, universal service high cost loop support, interconnection, UNEs and takings claims under the Fifth Amendment.

65 *Id.* at 20548.

66 *See* Section IV, *infra*. Because of the similarity of issues raised in the USTA petition with the issues presented in the *Depreciation Notice,* we consolidated the two proceedings. *See* Modification of Pleading Cycle for United States Telephone Association's Petition for Forbearance From Depreciation Regulation of Price Cap Local Exchange Carriers, 13 FCC Rcd 20345 (1998).

67 *See e.g.*, USTA Comments, Attachment A at 6-8.

68 *See* BellSouth Comments at 16; SBC Comments at 7; USTA Comments, Attachment A at 13.

69 AT&T Comments at 13-14; MCI-WorldCom Comments at 21.

70 Based on the record, we focus on the conditions under which we believe the largest price cap incumbent LECs could seek a waiver of the depreciation requirements.

71 The carriers maintain an integrated financial accounting system, which is used to extract data for various financial, management, tax, and regulatory purposes. To distinguish the difference in accounting for these various purposes, we refer to the FCC Part 32 accounts as "regulatory books" and the amounts reported to investors and the Security Exchange Commission ("SEC") as "financial books."

72 *See* Accounting for Judgments and Other Costs Associated with Litigation, *Report and Order*, 12 FCC Rcd 5112, 5116 (1997). Accounting for an expense "above-the-line" creates the rebuttable presumption that the expense will be allowed in the revenue requirement and will become the responsibility of ratepayers. Conversely, accounting "below-the-line" creates the rebuttable presumption that the expense will be disallowed in a rate case, making it the responsibility of the shareholders.

accounting purposes;[73] (3) foregoes the opportunity to seek recovery of the write-off through a low-end adjustment, an exogenous adjustment, or an above-cap filing;[74] and (4) agrees to submit information concerning its depreciation accounts, including forecast additions and retirements for major network accounts and replacement plans for digital central offices.[75] Finally, the waiver request must comply with section 1.3 of the Commission's rules.[76] We will consider alternative proposals by carriers seeking a waiver of our depreciation requirements.[77] Such alternative proposals, however, must provide the same protections to guard against adverse impacts on consumers and competition as the conditions adopted in this Order provide.

26. The first and second conditions of the waiver process we establish in this Order require that carriers seeking a waiver of our depreciation prescription process adjust their regulatory net book costs to their financial net book costs[78] and use the same depreciation factors and rates for both regulatory and financial accounting purposes. The first condition addresses the disparity that exists between the largest incumbent LECs' financial and regulatory books. In the early 1990's many of the largest incumbent LECs wrote off billions of dollars from their financial books through adjustments to their depreciation reserves.[79] Because they did not make

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[73] *See* GTE Comments at 2, 15.

[74] Requiring such voluntary actions by a carrier in exchange for obtaining benefits is not new. For example, incumbent LECs have recently been afforded, at their request, certain competitive pricing flexibility in exchange for their foregoing low-end adjustments. *See also* Access Charge Reform, *Fifth Report and Order and Further Notice of Proposed Rulemaking*, CC Docket No. 96-262, FCC 99-206, at ¶¶ 160-168 (rel. Aug. 27, 1999) (*Pricing Flexibility Order*).

[75] See ¶¶ 31-34, *infra*.

[76] Generally, as provided under our rules, a deviation from strict application of the Commission rules may be permitted for good cause shown. *See* 47 C.F.R. § 1.3. The Commission may grant a waiver where special circumstances warrant a deviation from the general rule, such deviation serves the public interest, and the waiver is consistent with the principles underlying the rule. *See* United States Telephone Association Petition for Waiver of Part 32 of the Commission's Rules, *Order*, 13 FCC Rcd 214 (Com. Car. Bur. 1997) (citing *Northeast Cellular Tel. Co. v. FCC*, 897 F.2d 1164 (D.C. Cir. 1990) ("*Northeast Cellular*"); *WAIT Radio v. FCC*, 418 F.2d 1153 (D.C. Cir. 1969), *cert. denied* 409 U.S. 1027 (1972) ("*WAIT Radio*")); *see also* Aliant Communications Co. Petition for Waiver of Section 32.27 of the Commission's Rules, *Order on Reconsideration*, DA 99-664, para. 6 (Com. Car. Bur. rel. Apr. *6, 1999)*.

[77] For example, SBC suggested an alternative proposal to allow a transitional mechanism over a period of 5-10 years for SBC to conform its regulatory books to its financial books. *See ex parte* letter from SBC to Magalie Roman Salas, FCC (December 16, 1999). Alternatively, BellSouth has suggested conditional forbearance, where a carrier agrees not to file any low-end adjustments or above-cap filings related to any depreciation change following forbearance. *See ex parte* letter from Kathleen B. Levitz, BellSouth to Magalie Roman Salas, FCC (December 14, 1999). These alternative proposals could be considered in a waiver proposal if they are designed to achieve the same protections we seek to assure with the waiver mechanisms described herein.

[78] Where financial net book costs are lower than regulatory net book costs, carriers should make an adjustment to their regulatory net book cost to reflect their financial net book costs. This would generally be accomplished by a below-the-line write-off by increasing the reserve balance on the regulatory books.

[79] In 1993, the largest price cap incumbent LECs began to announce that they would no longer rely on the provisions of Statement of Financial Accounting Standard No. 71 (SFAS-71) in their published financial statements. This resulted in a substantial write down in plant assets in the companies' published financial statement. Write-downs for this purpose were taken by US West (3rd Q, 1993); Bell Atlantic (3rd Q, 1994); Ameritech (4th Q, 1994); BellSouth (2nd Q, 1995); NYNEX (now Bell Atlantic) (2nd Q, 1995); Pacific Bell (now SBC) (3rd Q, 1995); SBC (3rd Q, 1995) and GTE (4th Q, 1995).

comparable write-offs on their regulatory books, there are significant differences in depreciation reserves between their financial and regulatory books. The first condition requires that the incumbent LEC eliminate this disparity by increasing the depreciation reserves on its regulatory books by a below-the-line write-off. The second condition then requires that carriers use the same depreciation factors and rates for both regulatory and financial purposes. Using the same factors and rates will ensure that established accounting procedures are being followed.[80] These conditions are important because they provide assurance that carriers do not engage in a practice that would disadvantage consumers and competition by using high financial depreciation rates with high regulatory net book costs or by applying inappropriate depreciation rates to regulatory plant accounts.

27. The third condition requires that carriers obtaining a waiver forego the opportunity to recover any portion of the adjustment that results from conforming their regulatory net book costs to their financial net book costs (*i.e.*, through a below-the-line write-off). As a precondition to obtaining a waiver of the depreciation prescription process, a carrier would have to voluntarily forego its opportunity to recover any portion of the one-time adjustment to its regulatory books through a low-end adjustment,[81] an exogenous adjustment[82] or an above-cap filing.[83] These are all mechanisms through which a price cap incumbent LEC can increase its prices by passing costs through to ratepayers. This third condition assures that a waiver from the depreciation prescription rules would not lead to unjust and unreasonable rates that would result from the inappropriate use of recovery mechanisms.[84] Foregoing recovery of any portion of the write-off is necessary because the depreciation prescription process is the primary way in which we evaluate such claims for recovery. If, as a condition of obtaining a waiver, an incumbent LEC voluntarily foregoes any opportunity to assert such claims in connection with this adjustment to its regulatory net book costs, then our concerns would be mitigated and we could conclude that a waiver of our rules is consistent with the public interest.[85]

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[80] The depreciation expenses reported on the carriers financial books are based on the use of financial depreciation rates with financial book balances that have been subject to substantial write-off in the early 1990's. These financial statements have been reviewed in accordance with SEC requirements and have been found to be free of material misstatements.

[81] Under the price cap rules, an incumbent LEC that fails to earn a specified minimum rate of return, currently set at 10.25 percent, may make a one-time adjustment to increase its rates to obtain that minimum return. 47 C.F.R. § 61.45(d)(1)(vii).

[82] An exogenous adjustment allows a carrier to increase its prices to recover costs imposed on it by governmental or administrative action beyond its control.

[83] Through an above-cap filing, a carrier could establish higher rates than would normally be permitted under price caps, if it provided cost support that justified higher rates. Increased depreciation expense could be a significant component of such a showing.

[84] Carriers no longer subject to Commission oversight of the depreciation process will be responsible for their depreciation rate decisions. We will carefully scrutinize the carriers depreciation rate decisions if these decisions trigger a low-end adjustment or if carriers seek recovery of high depreciation expense through other mechanisms.

[85] In light of the size of the potential claims and the intent expressed by some incumbent LECs to reserve the right to claim exogenous treatment for past reserve deficiencies, carriers would have to voluntarily forego their opportunity to recover such potential claims before we could find that unrestricted changes in depreciation practices were consistent with the public interest. *See* USTA Comments, Attachment A at 15. USTA contends that forbearance from depreciation cannot create an exogenous cost event, but creates an exception to that rule for "amortizations of past underdepreciated capital." Cincinnati Bell also states that "granting forbearance should not preclude price cap carriers from recovering reserve

28. These first three conditions are imposed in order to guard against adverse impacts on consumers and competition. Without these conditions, the largest incumbent LECs could use their high financial depreciation rates with their high regulatory net book costs, thereby drastically increasing their annual depreciation expenses. Large increases in depreciation expenses on the carrier's regulatory books would significantly reduce carrier's earnings, which in the case of most all the largest incumbent LECs, would be of such magnitude as to lower rates of return below 10.25%.[86] This in turn could trigger a low-end adjustment, or could lead to carriers seeking recovery through exogenous cost treatment or above-cap filings. These recovery mechanisms, if granted, could enable incumbent LECs to increase prices they charge for access services and in rates they charge for unbundled network elements (UNEs) and interconnection. Increases in access service prices, which could be substantial, would be imposed on purchasers of access and passed on to their customers. The harmful impact that increased charges could have on competition is also substantial. State regulatory commissions have set rates for interconnection and UNEs, and in many instances, have based the rates on Commission-prescribed depreciation factors. Incumbent LECs, acting as wholesale providers of critical facilities to their competitors, could independently establish depreciation rates that could result in unreasonably high interconnection and UNE rates, which competitors would be compelled to pay in order to provide competing local exchange service.

29. In addition, allowing the largest incumbent LECs to select their own financial depreciation rates for regulatory purposes could have serious consequences for the universal service process. All the largest price cap incumbent LECs are classified as non-rural for universal service purposes.[87] Under the rules we adopted in the recent federal high-cost support mechanism proceedings,[88] each of the non-rural carriers' high cost support is the larger of: (1) an amount determined under our previous USF calculation method, *i.e.*, by basing the amount of support on the relationship of the carrier's average cost per loop and the nationwide average cost per loop[89] or (2) an amount determined under the new synthesis model.[90] Our current depreciation prescription process is critical in the calculation of high cost support amounts determined under method (1) because it ensures that the depreciation expense component of the carriers' average costs per loop are reasonable. If we were to allow incumbent LECs to choose their own

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deficiencies that exist as a result of past depreciation regulation." Cincinnati Bell Comments at 10. *See also* Ad Hoc Reply at 8-12; US West Comments at 11.

[86] The Commission staff has estimated that based on the incumbent price cap LECs proposed lives in this proceeding (*see* Attachment B), depreciation expenses for the largest incumbent price cap LECs could potentially increase by 50%. Except for Ameritech, this large increase in depreciation expense would reduce the carriers' regulatory earnings below the 10.25% level, thus providing an opportunity for carriers to seek a low-end adjustment.

[87] The largest non-rural price cap incumbent LECs refer to the Regional Bell Operating Companies and GTE. *See* n. 59, *supra.*

[88] *See* Federal-State Joint Board on Universal Service, Ninth Report & Order and Eighteenth Order on Reconsideration, CC Docket No. 96-45, FCC 99-306, November 2, 1999 (*Ninth Report & Order on Universal Service*); and Federal-State Joint Board on Universal Service, Forward-Looking Mechanism for High Cost Support for Non-Rural LECs, Tenth Report & Order, CC Docket Nos. 96-45 and 97-160, FCC 99-304, November 2, 1999 (*Tenth Report & Order on Universal Service*).

[89] *See Ninth Report & Order on Universal Service* at ¶¶ 78-88.

[90] *See Tenth Report & Order on Universal Service* at ¶¶ 419-431.

depreciation factors without review, we could no longer ensure that the depreciation expense or the average cost per loop were reasonable. If these carriers were to use their financial depreciation factors for regulatory purposes, they would report major increases in their average costs per loop. This would increase substantially their high cost support under method (1). Under this method, however, because high cost support is subject to a cap, increases in the largest incumbent LECs' high cost support would not increase the fund. Instead, it would lead to substantial reductions in the high cost support for other, primarily rural, carriers, many of which rely to a great extent on high cost support to keep their local rates affordable.

30. In light of the significantly harmful impact that unrestricted changes in depreciation expenses could have on consumers and competition, we find the public interest is protected only if safeguards are in place that will negate such potential harm. We believe the first three conditions provide the appropriate safeguards and will ensure that carriers do not unreasonably increase depreciation expenses as a result of granting flexibility to establish their own depreciation rates.

31. The fourth condition requires that carriers who obtain a waiver of our depreciation process submit certain information about network retirement patterns and modernization plans related to their plant accounts so that we can maintain realistic ranges of depreciable life and salvage factors for each of the major plant accounts.[91] This condition seeks to ensure that the Commission has the necessary data to periodically update depreciation factors (*i.e.*, life, salvage, curve shape, depreciation reserve) and to address issues in areas where reliance on the carriers' financial depreciation rates may be inconsistent with other regulatory policy goals.[92] Maintaining appropriate depreciation ranges for the major plant accounts will continue to be critical even though some carriers may be granted relief from the Commission's prescribed depreciation process. This is especially true given the Commission's reliance on the prescribed depreciation ranges in the use of its cost models for universal service high cost support and UNE/interconnection prices.[93]

32. As discussed above, calculation of high cost support under method (2) uses the synthesis model.[94] In this model, the Commission determined that it would rely on the weighted average of the prescribed lives and salvage percentages.[95] If we were to discontinue depreciation prescription for most carriers, these weighted average factors would become less representative of the industry as a whole. In such a circumstance, in order to have representative depreciation factors, we would likely have to rely on the Commission's prescribed depreciation ranges. In order to do this successfully, however, we would have to require that all the major carriers continue to provide the data necessary to keep the ranges up-to-date.

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91 *See* ¶ 34, *infra.*

92 This would be the case, for instance, when subsidies or rates are largely driven by costs, including universal service high cost support and rates for unbundled network elements (UNEs) and interconnection.

93 *See* ¶ 32-33, *infra.* We also note that depreciation is a significant factor in the calculation of pole attachment rates, and we are concerned that significant increases in depreciation would adversely affect competition by increasing the costs that competitors must pay to provide local exchange service. Because this issue was not discussed by any party, we will not, in this proceeding, impose any requirements pertaining to the calculation of pole attachment rates. In any consideration of a petition for waiver of the depreciation requirements, however, we will consider whether it is in the public interest to allow carriers to use their financial book depreciation lives in the calculation of pole attachment rates.

94 *See Tenth Report & Order* at ¶¶ 419-431.

95 *Id.* at ¶ 431.

33. Further, in the *Local Competition Proceeding*, the Commission required the use of "economic depreciation" in calculating rates for interconnection and UNEs, but did not elaborate on how economic depreciation should be calculated.[96] Based on our review to date, twenty-four states commissions have required incumbent LECs to use FCC-prescribed projection lives and salvage factors, or similar state-prescribed factors, to calculate their rates for UNEs.[97] We are concerned that forbearance from depreciation regulation by the Commission might deprive state regulatory commissions of valuable information that they may want or need in setting rates for interconnection and UNEs,[98] and might enable incumbent LECs to raise arbitrarily the rates for essential inputs that competitors must purchase from the incumbent LECs. This could have an adverse impact on the development of local competition.

34. Thus, in order to prevent any inappropriate and undesirable fluctuations in high cost support or the rates for interconnection and UNEs due to changes in depreciation rates caused by carriers receiving a waiver, we will continue to maintain realistic ranges of depreciable life and salvage factors for each of the major plant accounts. These ranges can be relied upon by federal and state regulatory commissions for determining the appropriate depreciation factors to use in establishing high cost support and interconnection and UNE prices. The information that carriers will be required to submit include: forecast additions and retirements for major network accounts; replacement plans for digital central offices; and information concerning relative investments in fiber and copper cable.[99] This condition will assure that any increase in depreciation expense will not have a harmful effect on consumers or competition in rates calculated using reported costs or forward-looking cost models.

35. The four conditions outlined above are intended to mitigate our concerns about the adverse impacts that could occur when carriers are given the freedom to select their own depreciation lives and procedures. The depreciation prescription process is our primary method of assessing the validity of the incumbent LECs' claims for reserve deficiencies and it would not be in the public interest to waive our depreciation rules with the issue of billions of dollars in

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[96] Implementing the Local Competition Provisions in the Telecommunications Act of 1996, *First Report and Order*, 11 FCC Rcd 15499, at ¶703 (1996).

[97] *See, e.g.* Texas, Docket 16189, et al., November 8, 1996; Massachusetts, Docket DPU 96-73/74 et al., December 4, 1996; New York, Docket 95-C-0657, et al., April 1, 1997; West Virginia, Docket 96-1516-T-PC, April 21, 1997; Wyoming, Docket 70000-TF-96-319, 72000-TF-96-95, April 23, 1997; Delaware, Docket 96-324, April 29, 1997; Ohio, Docket 96-922-TP-UNC, June 19, 1997; Colorado, Docket 96S-331T, July 28, 1997; Maryland, Docket 8731, Phase II, September 22, 1997; Louisiana, Docket U-22022/22093, October 22, 1997; Georgia, Docket 7061-U, December 16, 1997; Illinois, Docket 96-0569, February 17, 1998; Virginia, Docket 970005, May 22, 1998; Michigan, Case No. U-11280, July 14, 1997. Alabama, Florida, Hawaii, Mississippi, Nevada, New Hampshire, New Jersey, North Carolina, South Carolina, and Tennessee also rely on FCC prescribed rates. *See also*, MCI-WorldCom Comments at 7, n. 16; AT&T Comments at 20.

[98] The Commission's pricing rules for interconnection and UNEs had been vacated by the Eighth Circuit Court of Appeals *Iowa Utilities Board v. FCC*, 120 F. 3d 753, 800, 804, 805-806 (8th Cir. 1997). The Supreme Court reversed the Circuit Court decision and reinstated the Commission's jurisdiction to specify pricing rules that the state commissions must follow in setting prices for interconnection and unbundled network elements. *AT&T Corp. v. Iowa Utilities Board*, 119 S.Ct. 721 (1999).

[99] We delegate to the Common Carrier Bureau the authority to determine the details and specifications of the information to be submitted consistent with our decision here. We expect staff, to the extent possible, to work with the industry to have the necessary information from the carriers provided in a form that is readily available from the carriers' records.

potential claims unresolved. By establishing conditions pursuant to which a waiver from the depreciation prescription process would be granted, we are giving carriers the freedom from depreciation regulation that they seek. In exchange for that freedom, however, they would need to relinquish portions of the regulatory safety net that has protected them in the past.

H. Other Issues

36. This proceeding has raised four other possible areas in which a change in depreciation expense could have a significant impact: a recalculation of the productivity factor, a calculation of the Base Factor Portion (BFP), the pricing of new services, and the monitoring of price caps.[100] We conclude with respect to each of these areas that the impact of changes in depreciation rates is too insignificant to require that conditions related to these factors be met prior to any grant of a waiver from depreciation regulation.

37. The *Depreciation Notice* requested comment on whether changes in depreciation would affect a recalculation of the productivity, or X-factor. Productivity is the ratio of a firm's output and its input. Its output is typically measured by its operating revenue; its input is measured by its operating expense. In the telecommunications industry, depreciation expense is the largest expense, representing nearly 30% of operating expenses. If the depreciation expense is altered substantially, the productivity factors could similarly change. The Commission has already stated that, if we permit price cap LECs to develop their own depreciation rates, we will determine the effect of the revised depreciation rates on total factor productivity (TFP) and the X-Factor in our next performance review.[101] We have already anticipated, therefore, that we might take deregulatory actions with regard to depreciation and are prepared to deal with them in another proceeding.

38. The *Depreciation Notice* also requested comment on the effect of changes in the depreciation prescription process on the calculation of the Base Factor Portion (BFP)[102] of the common line costs. The BPF helps us determine the relative portion of common line costs that are recoverable through per-line and per-minute access charges. If carriers comply with the conditions specified in paragraph 25, above, especially condition one to take a below-the-line

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[100] *Depreciation Notice*, 13 FCC Rcd at 20546. In the *Notice*, we requested comment on the recalculation of the productivity factor and the calculation of the Base Factor Portion. AT&T suggests that changes in depreciation methodology could also have a significant impact in two additional ways, the pricing of new services and the monitoring of price cap performance. AT&T Comments at 16.

[101] *See* Price Cap Performance Review for Local Exchange Carriers, *Fourth Report and Order in CC Docket No. 94-1 and Second Report and Order in CC Docket No. 96-262*, 12 FCC Rcd 16642, 16671 (1997) (*Fourth Performance Review Order*).

[102] Under our rules, the carriers establish a total revenue requirement for the entire Common Line basket. Carriers then calculate a Base Factor Portion (BFP), which determines how much of the revenue requirement in the Common Line basket can be recovered through End User Common Line charges. If these end user charges do not recover the entire common line revenue requirement, price cap LECs may assess, subject to specified caps, a monthly, flat-rated charge on a customer's primary interexchange carrier, known as the primary interexchange carrier charge (PICC). The portion of the revenue requirement that is not obtained from the fixed charges is divided by minutes of use and assessed as a per-minute Carrier Common Line charge on the IXCs. As revenues from the fixed charges increase, the carriers will be able to recover an increasing amount of their revenue requirement from these fixed charges. When carriers can recover enough from their fixed charges to cover their entire revenue requirement, costs, including depreciation, will no longer be used to calculate the BFP and will no longer determine the revenue requirement for the Common Line Basket.

write off, and we allow their use of financial depreciation factors, the resulting depreciation expenses will not change substantially. Thus, the BFP calculations will be largely unaffected. We therefore conclude that, as long as carriers comply with the conditions specified in this Order, waiver of our depreciation rules will not adversely affect the BFP calculations or the common line access charges generally.

39. Commenters also expressed concern about the impact that changes in depreciation expense might have on the establishment of rates for new services.[103] Under the new services test, a carrier filing a tariff for a new service was required to show that its rates will recover no more than its direct cost of providing the service, plus a reasonable level of overhead.[104] In the past, we have been able to ensure that carriers have based their proposed prices for new services on realistic depreciation factors by reviewing the cost support and determining whether they used depreciation rates consistent with their prescribed depreciation rates. As stated earlier, we fully intend to maintain realistic ranges of depreciable life and salvage factors for each of the major plant accounts. Thus, even if we waive the depreciation prescription rules for certain carriers, we will be able to ensure realistic depreciation factors by determining whether the life estimates underlying their cost support are within the prescribed depreciation ranges. Thus, we find that allowing carriers to select their own depreciation rates will not have a significant overall adverse impact on price cap indexes through increased rates for new services.

40. Finally, commenters expressed concern about the impact of changes in depreciation expense on the Commission's ability to monitor price cap performance. These parties assert that without Commission oversight of the deprecation process, carriers will select unrealistically low life estimates thereby overstating depreciation expenses and understating earnings. They believe carriers will do this to conceal high earnings so that the Commission will not consider making corrective adjustments to the price cap rules or factors.[105] Although increases in depreciation expense would clearly have an impact on the price cap earnings that the carriers would report, we believe that by maintaining realistic life and salvage ranges we will be able to determine realistic depreciation expenses and earnings, even if the carriers choose to report unrealistic depreciation expenses and earnings. Thus, we believe our tariffing and enforcement powers are sufficient to deal with any problems that might arise and hence satisfy monitoring concerns. On balance, we find that the benefits of waiving our depreciation prescription requirements would outweigh any problems that might develop in monitoring the carriers' price cap performance.

IV. UNITED STATES TELEPHONE ASSOCIATION'S PETITION FOR FORBEARANCE

41. On September 21, 1998, USTA filed a petition for forbearance[106] on behalf of the price cap incumbent LECs and requested that the Commission forbear from imposing Sections

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103 AT&T Comments at 18; MCI-WorldCom Comments at 5; GSA Reply at 11.

104 Under the price cap rules in effect when comments were filed in this proceeding, the new services test was required for all new services. 47 C.F.R. § 61.42(g). We recently changed our rules to eliminate the new services test except for loop-based services. *See also Pricing Flexibility Order* at ¶ 42 (requirements for loop-based services are being considered by the Commission with the Joint Board).

105 *See e.g.*, AT&T Comments at 18, MCI-WorldCom Comments at 5.

106 *See* n. 4, *supra.*

32.2000(g)[107] and 43.43 of the Commission's rules,[108] and refrain from conducting depreciation prescription proceedings under section 220(b) of the Act.[109] In its petition, USTA contends that the Commission's 1997 elimination of the sharing mechanism[110] ended a major reason for retaining depreciation regulation of incumbent LECs.[111] USTA also argues that depreciation regulation is not necessary to ensure just and reasonable rates because, under price cap regulation, any link between the Commission's depreciation prescriptions and a LEC's charges is extremely attenuated.[112] USTA contends that depreciation prescription is not needed to protect consumers, but rather harms them by imposing unnecessary administrative burdens and costs on price cap incumbent LECs and the Commission. USTA also contends that forbearance from depreciation regulation is in the public interest because it would promote competition by improving the efficiency of price cap incumbent LECs' operations and by eliminating burdens that incumbent LECs face relative to competitive LECs and IXCs, whose depreciation is not regulated by the Commission.[113] Seven parties, all incumbent LECs, support USTA's petition[114] and six parties oppose it.[115]

42. The USTA petition is filed under section 10 of the Act.[116] Section 10 provides that the Commission shall forbear from applying any regulation or any provision of the Act to a telecommunications carrier or service, or class of telecommunications carriers or telecommunications services, in any or some of its or their geographic markets, if the Commission determines that:

(1) enforcement of such regulation or provision is not necessary to ensure that the charges, practices, classifications, or regulations by, for, or in connection with that telecommunications carrier or telecommunications service are just and reasonable and are not unjustly or unreasonably discriminatory;
(2) enforcement of such regulation or provision is not necessary for the protection of consumers; and

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107 47 C.F.R. § 32.2000.

108 47 C.F.R. § 43.43.

109 47 U.S.C. § 220(b).

110 *Fourth Performance Review Order*, 13 FCC Rcd 16701. The sharing mechanism provided that carriers would share some portion of earnings with their customers through future price reductions. These sharing obligations were established, *inter alia*, to ensure that errors in setting prices under the price cap formula would not lead to unreasonably high rates and to ensure that reduction in costs were passed through to each carrier's customers.

111 USTA argues that a major reason that the Commission retained depreciation regulation of the LECs was to safeguard the sharing mechanism so that carriers could not manipulate costs. With the elimination of the sharing mechanism, USTA argues, the need for depreciation regulation is no longer necessary. USTA Comments at 5.

112 USTA Comments, Attachment A at 13. *See also* Bell Atlantic Comments at 1.

113 USTA Petition at i – ii.

114 Ameritech Comments at 2; Bell Atlantic Comments at 2; BellSouth Comments at 11; Cincinnati Bell Comments at 3; GTE Comments at 19; SBC Comments at 28; US West Comments at 3.

115 Ad Hoc Comments at 3; AT&T Comments at 10; GSA Comments at 9; MCI-WorldCom Comments at 2; New Networks Institute at 3; Virginia Comments at 5.

116 47 U.S.C. § 160.

(3) forbearance from applying such provision or regulation is consistent with the public interest.[117] In this respect, the Commission is to weigh the competitive effects of forbearance to determine whether such forbearance will promote competitive market conditions.[118]

A. Just and Reasonable Rates

43. The first prong of the section 10 analysis requires us to find, as a precondition to granting forbearance, that enforcement of such regulation is not necessary to ensure that the charges are just and reasonable. As discussed below, we find that unrestricted changes in depreciation practices could prevent us from ensuring that increases in carriers' rates are just and reasonable. Thus, we find that our depreciation prescription process is necessary to ensure just and reasonable charges.

44. Were the Commission to grant USTA's petition, the Commission would forbear from enforcing its depreciation accounting requirements, thus providing incumbent LECs the freedom to make various changes to current depreciation practices. For example, carriers could adopt much shorter lives for their telecommunications plant and record much greater depreciation expense in an accounting period than they do under the current rules. Non-LEC commenters argued that, without Commission oversight, a carrier's depreciation could be manipulated to reduce its earnings below the low-end adjustment trigger of 10.25 percent.[119] Changes in depreciation expense alone could reduce a carrier's earnings by several percentage points.[120] This could in turn trigger a low-end adjustment and enable carriers to raise their prices under price cap regulation.

45. This low-end adjustment would be implemented by allowing an incumbent LEC to make an exogenous cost change to retarget its price cap index (PCI) if its base year earnings provide a rate of return that is below a specified level.[121] That level is currently set at 10.25 percent.[122] If an incumbent LEC's interstate rate of return falls below that threshold, it is allowed to make a one-time adjustment to increase its PCI, and consequently its rates, to yield a 10.25 percent rate of return. Given the freedom to select their own depreciation rates, some incumbent LECs could choose to increase depreciation expense enough to reduce their rate of return below the low-end adjustment trigger.[123]

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117 47 U.S.C. § 160(a).

118 47 U.S. C.§ 160(b).

119 Florida Comments at 8; GSA Reply at 4-5; MCI-WorldCom Comments at 2.

120 *See ex parte* letter from Gerald Asch, Bell Atlantic, to Magalie Roman Salas, FCC (June 24, 1999).

121 47 C.F.R. § 61.45(d)(1)(vii).

122 Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5 FCC Rcd 6786, 6804, ¶¶ 147-49 (1990) (*LEC Price Cap Order*), *Erratum*, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), *modified on recon.*, 6 FCC Rcd 2637 (1991); *aff'd sub nom. National Rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993).

123 In 1998, Southwestern Bell had a rate of return below the 10.25 percent trigger even without increased depreciation expense. ARMIS Report 43-01, Table 1. Southwestern Bell filed a tariff review plan on April 2, 1999 that claimed a $76 million low-end adjustment. Public Notice, 14 FCC Rcd 3482 (1999). SBC revised its filing in June 1999, claiming a $17 million low-end adjustment. *See* Southwestern Bell Telephone Tariff FCC No. 73, Transmittal 2763 (filed Jun. 16, 1999).

46. Recognizing the effect of depreciation on price cap rates through the low-end adjustment, BellSouth proposes that the Commission allow any carrier to set its own depreciation rates if it agrees to waive its rights to an automatic low-end adjustment.[124] Although BellSouth's proposal is a positive step, it is limited because the carrier would only waive the automatic aspect of the low-end adjustment. The carrier would still retain the right to request a low-end adjustment upon a showing that its depreciation expense in a particular situation is proper.[125] As non-LEC commenters note, however, forbearance would eliminate all oversight of the depreciation process, providing the Commission with little or no basis on which to evaluate the reasonableness of the incumbent LECs' claimed depreciation expense. BellSouth's proposal is also limited to the current price cap plan and any major change in that plan could reinstate the need for a low-end adjustment.[126] Because of its limited nature, the BellSouth proposal would not allow us to ensure just and reasonable rates if we were to forbear from depreciation prescription.[127]

47. Some incumbent LECs contend that we need not be concerned about the impact of the low-end adjustment because carriers have rarely used it.[128] We disagree. Our depreciation prescription process has previously constrained incumbent LECs' ability to reduce their reported earnings below the low-end adjustment trigger by increasing their depreciation expenses artificially.[129] Forbearance would eliminate this constraint. If we were to forbear from all depreciation regulation, incumbent LECs would have both the ability and the incentive to trigger the low-end adjustment by establishing new, shorter depreciation projection lives that would allow the carrier to record larger depreciation expenses in any particular accounting period. Further, non-LEC commenters note that the requested forbearance would eliminate all oversight of depreciation. Without such oversight, the Commission would have little or no basis on which to evaluate the reasonableness of the incumbent LECs' claimed depreciation.[130] Since depreciation expense is an incumbent LEC's largest single cost,[131] inflated claims for depreciation expense could result in increased rates and could hamper our ability to ensure just and reasonable rates.

48. Incumbent LECs also contend that, if we were to forbear, generally accepted accounting principles (GAAP) would prevent excessive depreciation expense and thereby ensure just and reasonable rates.[132] We disagree. An incumbent LEC using GAAP would have substantial latitude to select different methods of depreciation, such as accelerated depreciation, that could significantly alter the depreciation expense that the LEC could claim.[133] Additionally,

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124 *See* BellSouth Comments at 16.

125 BellSouth Comments at 17. *See also* US West Comments at 7; USTA Comments, Attachment A at 14.

126 BellSouth Comments at 17.

127 Ad Hoc Reply at 7.

128 SBC Comments at 7; Bell Atlantic Comments at 6-7; Ameritech Comments at 7; USTA Petition at 12; Cincinnati Bell Comments at 4.

129 GSA Reply at 4-5.

130 *Id.*

131 *See* ¶ 3 and n. 11, *supra.*

132 Ameritech Comments at 2; BellSouth Comments at 4-5; US West Comments at 12; USTA at 13.

133 *See* 47 C.F.R. § 32.2000(g). The Commission's rules require incumbent LECs to use straight-line

the Commission has previously rejected the incumbent LECs' argument, stating that "GAAP is guided by the conservatism principle which holds, for example, that, when alternative expense amounts are acceptable, the alternative having the least favorable effect on net income should be used."[134] The Commission concluded that, although conservatism is effective in protecting the interests of investors, it may not always serve the interests of ratepayers, and did not offer adequate protection for ratepayers in the case of depreciation accounting.[135] We are not persuaded that the role of the conservatism principle in GAAP has changed or that we should change our previous decision. Incumbent LECs contend that the other principles of GAAP are sufficient to protect the interests of ratepayers.[136] We believe that giving incumbent LECs the right to select, for regulatory purposes, any depreciation rate allowed by GAAP is inappropriate as long as incumbent LECs reserve the right to make claims for regulatory relief based on the increased depreciation that would result from granting them that flexibility.

49. Incumbent LECs contend that regulatory safeguards other than Commission depreciation rules, such as SEC regulation, stock exchange listing requirements, and an annual external audit, will protect ratepayers against unjustified rate increases that carriers seek to implement through the low-end adjustment or other mechanisms.[137] We disagree. These other safeguards, such as SEC requirements, are not adequate substitutes for depreciation prescription because they are not designed to protect ratepayers, but are designed to protect investor interests.[138] We also find that reliance on the Commission's Section 208 complaint process[139] would be an inefficient means to protect ratepayers from the effects of over-depreciation at this time. Absent our depreciation prescription process, we would have no established standard against which to consider the lawfulness of a carrier's claimed depreciation. If we were to judge a carrier's proposed depreciation expense by a general standard, such as the requirement that carriers charge just and reasonable rates,[140] we would be mired in a series of protracted and contentious disputes.

50. Many incumbent LECs propose that, after forbearance, we could ensure that rates are just and reasonable by evaluating the depreciation expense each time a carrier filed for a low-end adjustment or other regulatory relief.[141] We do not believe that it would be either effective or

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depreciation. The incumbent LECs could significantly increase their depreciation expense by using one of the forms of accelerated depreciation permitted under GAAP.

134 *Depreciation Simplification Order*, 8 FCC Rcd at 8044.

135 *Id. See also* AT&T Comments at 21.

136 US West Comments at 12 (relevance, reliability, neutrality, comparability, consistency, materiality and costs and benefits are other principles); BellSouth Comments at 5.

137 US West Comments at 12. *See also* BellSouth Comments at 10.

138 AT&T Comments at 22. *See also* discussion in ¶ 48, *supra.*

139 47 U.S.C. § 208.

140 47 U.S.C. § 201(b).

141 SBC Comments at 8. *See also* BellSouth Comments at 22; Sprint Comments at 14; USTA Petition at 12; USTA Comments, Attachment A at 13; US West Comments at 7; Cincinnati Bell Comments at 4. Other parties argued that such a case-by-case review of depreciation expense would serve the same function in other contexts, such as a takings claim or an above-cap filing. We disagree that a case-by-case review would be adequate for the same reasons that we reject this proposal in the context of a low-end adjustment.

efficient to evaluate each carrier's depreciation rates on a case-by-case basis. If we forbear from depreciation prescription, the carriers would be free to keep only the depreciation records necessary for accounting according to GAAP and would not be required to keep information about recent and planned equipment retirements, which are currently required by section 43.43 of the Commission's rules[142] and are necessary for us to calculate the depreciation rates. The incumbent LECs also suggest that, after forbearance, other methods could substitute for our depreciation prescription process and thereby ensure just and reasonable rates. These suggestions include creating a rebuttable presumption that depreciation rates of the applying carrier that are used for financial reporting purposes are correct.[143] Establishing such a presumption, however, would place the burden on other parties, as well as on the Commission, to produce evidence that rebuts the carrier's claim. As a practical matter, such a presumption would be tantamount to conceding that incumbent LECs' claims for regulatory relief are valid since access to information about the carriers' depreciation practices would not be publicly available and would not be subject to regulatory scrutiny under a grant of forbearance. Further, the incumbent LECs' financial books would contain only the amount of depreciation and would not provide adequate information to evaluate claims for regulatory relief.

51. Another suggested substitute for the depreciation prescription process is that the Commission could establish test criteria for evaluating the depreciation expense that incumbent LECs claim in connection with a request for a low-end adjustment or other regulatory relief.[144] Again, it would be difficult to create objective test criteria to evaluate independently the incumbent LECs' claimed depreciation expense when the only information about depreciation would be that contained in their financial books. SBC suggests that the Commission could simply reserve the right to use the carrier's most recently prescribed depreciation rates to evaluate its request for a low-end adjustment or other regulatory relief.[145] While that approach partially addresses our concerns, we find that it is inadequate because it makes no provision for updating the depreciation rates and factors that we would have to apply for the foreseeable future. Carriers are already maintaining that their prescribed rates are out of date and that approach would exacerbate the alleged problem.[146] Incumbent LECs also suggest that the Commission could establish surrogates based on an average of depreciation factors employed for comparable equipment by large, unregulated competitors to the incumbent LECs.[147] We believe that the equipment used by the incumbent LECs and such surrogate companies is not clearly comparable. Specifically, we find that the degree of imprecision that would be inherent in using companies from other segments of the telecommunications industry would make the process less effective, more contentious, and more burdensome than the existing depreciation prescription process. For the reasons discussed above, therefore, we believe that use of the various substitutes for depreciation prescription suggested by the incumbent LECs would hinder our ability to establish just and reasonable rates.

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142 47 C.F.R. § 43.43.

143 Bell Atlantic Comments at 7.

144 BellSouth Comments at 16-17.

145 SBC Comments at 7.

146 Bell Atlantic Reply at 3; SBC Comments, Exhibit A at 18-19; US West Reply at 9; BellSouth Comments at 12.

147 GTE Comments at 16-17.

52. SBC contends that our consideration of the impact of deregulating depreciation on the low-end adjustment is inconsistent with our previous orders. SBC argues that those orders cited the existence of the sharing mechanism as the primary reason for continuing to regulate depreciation.[148] We disagree. The Commission's *Depreciation Simplification Order* gave two reasons for not further deregulating depreciation at that time: the existence of the sharing mechanism and the fact that incumbent "LECs [did] not yet face significant competition."[149] In the present case, our analysis of the ways in which depreciation continues to be significant under price caps is directly relevant to the issue of competition and whether continued depreciation regulation is necessary because of a lack of competition. Our previous concerns about competition, therefore, are still relevant today. Additionally, section 10 of the Telecommunications Act of 1996 added a variety of factors, including the impact on competition, that we must consider when determining whether forbearance from a particular rule is appropriate.[150] Our request for comments on whether depreciation is still significant under price cap regulation is in accordance with the Commission's prior orders and with the controlling statutes.[151]

53. Further concerns were expressed that, if the Commission were to forbear from imposing depreciation requirements, an incumbent LEC could adjust depreciation factors to increase the cost of bottleneck network components that competitors would require, while simultaneously reducing the costs of other network components that underlie the incumbent LECs' competitive services but are not used by competitors.[152] Under the current rules, depreciation rates are generally set for a large area, like a study area, and for a plant account that generally includes a broad range of equipment. This requirement, that carriers set rates for broad geographical and equipment categories, would make it more difficult for a carrier to segregate its equipment so that the resulting rates discriminate against a class of customers or a geographic region. In the absence of our rules, we believe such discrimination could occur.

54. USTA contends that competition alone is sufficient to constrain the incumbent LECs' ability to manipulate depreciation expense. It cites the thousands of interconnection agreements that incumbent LECs have negotiated with alternative providers of local exchange service, competition from wireless and personal communications services, and the freedom that cable companies and public utilities now have to enter telecommunications.[153] Non-LEC commenters disagree, noting that the *Depreciation Notice* had stated that the local exchange market was not sufficiently competitive to allow us to deregulate depreciation and that the incumbent LECs had a 97 percent share of the local exchange market in 1997.[154] MCI-

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148 SBC Comments at 2.

149 *Depreciation Simplification Order,* 8 FCC Rcd at 8033.

150 47 U.S.C. § 160(a) & (b).

151 *See Depreciation Notice,* 13 FCC Rcd at 20546. Specifically, in the *Depreciation Notice,* we requested comment on the impact that changes in depreciation would have under price cap rules on the calculation of a low-end adjustment, a recalculation of the productivity factor, an exogenous cost determination, a calculation of the Base Factor Portion, an above-cap filing, universal service high cost loop support purposes, calculation of rates for interconnection and UNEs and a takings claim under the Fifth Amendment).

152 AT&T Comments at 13-14.

153 USTA Comments, Attachment A at 6-7. *See also* US West Comments at 5.

154 AT&T Comments at 12; *citing Depreciation Notice,* 13 FCC Rcd at 20547.

WorldCom, for example, maintains that, at the current level of competition, depreciation regulation remains necessary to ensure that incumbent LEC rates are just and reasonable and not unreasonably discriminatory.[155] Additionally, we have found in our consideration of the incumbent LECs' applications requesting approval to provide interLATA interexchange services under section 271, that the carriers do not yet face competition for local exchange services in many states.[156] We conclude that USTA has not demonstrated that the local exchange market is sufficiently competitive to make depreciation prescription unnecessary.

55. We note that we recently established standards under which qualifying incumbent LECs may elect to have pricing flexibility.[157] The *Pricing Flexibility Order* eliminates the low-end adjustment for carriers that choose pricing flexibility.[158] Our elimination of the low-end adjustment for qualifying carriers, however, does not moot concerns about the low-end adjustment in this proceeding. Until all carriers qualify and elect pricing flexibility and, consequently, have their right to the low-end adjustment eliminated, the concerns expressed in this forbearance analysis continue to be relevant.

56. As discussed in detail above, we find that forbearing from depreciation prescription would hamper our ability to ensure just and reasonable rates by reducing our ability to prevent unjustified rate increases through the low-end adjustment and other mechanisms. We further find that none of the alternatives proposed by the incumbent LECs are sufficient to alleviate these concerns. Additionally, we find that our action here is consistent with our previous orders simplifying the depreciation prescription process. Accordingly, the first prong of the section 10 forbearance test is not satisfied.

B. Protection of Consumers

57. The second prong of the section 10 analysis requires us to find, as a precondition to granting forbearance, that enforcement of such regulation is not necessary for the protection of consumers.[159] As discussed below, we find that continuation of our depreciation prescription process is necessary for the protection of consumers.

58. USTA and the incumbent LECs claim that depreciation regulation imposes hundreds of thousands of dollars in administrative burdens and costs on price cap LECs[160] that carriers would not have to incur if we were to forbear from the prescription of depreciation. Incumbent LECs also contend that the Commission's administrative costs would be reduced through forbearance and that consumers would benefit because of the elimination of the administrative expenses incurred by both the incumbent LECs and the Commission.[161] We

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155 MCI-WorldCom Comments at 4.

156 *See* Application of BellSouth Corporation, *et.al.* Pursuant to Section 271 Communications Act of 1934, as amended, To Provide In-Region, InterLATA Services in South Carolina, 13 FCC Rcd 539 (1997).

157 Access Charge Reform, *Fifth Report and Order and Further Notice of Proposed Rulemaking*, CC Docket No. 96-262, FCC 99-206, (rel. Aug. 27, 1999) (*Pricing Flexibility Order*).

158 *Id.* at ¶ 162.

159 47 U.S.C. § 160(a)(2).

160 According to one study, the incumbent LECs would save, on average, $400,000 per year if depreciation expense practices were simplified. SBC Comments, Exhibit A at 5.

161 USTA Comments at 2; BellSouth Comments at 10; Cincinnati Bell Comments at 10; GTE

disagree. We believe that, under forbearance, the administrative costs of evaluating the depreciation components could equal or exceed the administrative costs imposed by the existing depreciation process. For instance, any purported cost savings for both carriers and the Commission would be illusory in the case where, instead of our existing depreciation prescription process, parties incur administrative and regulatory expenses because of contentious and protracted case-by-case reviews of the appropriateness of the depreciation claimed by incumbent LECs.

59. We find further that even if the carriers are correct in asserting that our depreciation process imposes higher administrative costs than would occur under forbearance, any savings in administrative costs could easily be outweighed by costs imposed on consumers by increased rates. Forbearance of the depreciation prescription process could potentially trigger large increases in a carrier's depreciation expenses, which could in turn result in unwarranted increases in consumer rates.[162] These increased depreciation expenses and consumer rates would likely to continue for many years until robust competition curtails the ability of the incumbent LECs to secure these rates from consumers.

60. Additionally, we find that forbearance from depreciation prescription could harm consumers, particularly customers served by rural carriers, by effectuating a re-direction of high cost support from the rural carriers to the non-rural carriers.[163] This could occur because of the way in which high cost support is calculated under the Commission's recent decision. Under our recent decision, a carrier's high cost support is the higher of (1) an amount determined under our previous USF calculation method, *i.e.*, by basing the amount of support on the relationship of the carrier's average cost per loop and the nationwide average cost per loop and (2) an amount determined under the new synthesis model.[164] Under the first method for calculating high cost support, depreciation expense is a critical component of the carriers' average costs per loop. If we were to grant forbearance from our depreciation requirements to the price cap incumbent LEC and allow them to establish their own depreciation factors without review, we could no longer ensure that the depreciation expense or the average cost per loop were reasonable. If the largest incumbent LECs used shorter depreciation lives, thus increasing their depreciation expense, they would report significant increases in their average costs per loop, resulting in substantial increases in their high cost support under method (1) above. Because the amount of high cost support is capped, however, increases in the largest incumbent LECs' high cost support would not increase the fund but would instead lead to substantial reductions in the amount of high cost support for other, mostly rural, carriers.

61. We disagree with the incumbent LECs' contention that the use of Commission-prescribed lives is inappropriate for calculating the forward-looking costs of providing universal service because the Commission-prescribed lives are historical and backward-looking.[165]

Comments at 21; Bell Atlantic Comments at 4.

[162] AT&T Comments at 12-13; MCI-WorldCom Comments at 19-20.

[163] All the largest price cap incumbent LECs are classified as non-rural for universal service purposes.

[164] *See* ¶ 29, *supra.*

[165] Bell Atlantic Comments at 7; US West Comments at 9; BellSouth Comments at 21-22; SBC Comments at 12-13; USTA Comments, Attachment A at 18.

Indeed, this argument has little merit, particularly in light of our recent decisions implementing federal high-cost support mechanisms.[166] In adopting a forward-looking mechanism for high-cost support, we found that depreciation expense calculations based on the Commission's prescribed projection lives and salvage factors represent the best forward-looking estimates of depreciation lives and net salvage percentages.[167] Some incumbent LECs contend that the Commission's depreciation prescription process puts them at a disadvantage in the calculation of high cost support when compared with other providers of universal service, whose depreciation rates are not regulated by the Commission.[168] We do not agree. High cost loop support, under method (1) is calculated for all providers based on a nationwide average of the most recently prescribed depreciation factors for incumbent LECs.[169] In fact, if we were to grant forbearance, adoption of dramatically shorter lives by the incumbent LECs[170] could greatly disadvantage other carriers.

62. Based on the foregoing discussion, we conclude that the administrative costs incurred under forbearance could equal or exceed those incurred under our existing depreciation prescription process. Thus, any savings in administrative costs would likely be outweighed by costs imposed on consumers by increased rates and could raise incumbent LECs' requirements for high cost support. We therefore are not able to conclude that our depreciation prescription process is not necessary for the protection of consumers.

C. Public Interest and Effect on Competition

63. The third prong of the section 10 analysis requires us to find, as a precondition to granting forbearance, that forbearance from applying such regulation is consistent with the public interest.[171] As discussed in detail below, we believe that, under forbearance, increased depreciation expense could be translated into higher rates through exogenous adjustments and above-cap filings.[172] We conclude that forbearing from depreciation prescription where the potential result is higher rates is not in the public interest. Section 10 also requires us to consider,

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166 *See* ¶ 29, *supra*; *Ninth Report & Order on Universal Service* at ¶¶ 78-88; *Tenth Report & Order on Universal Service* at ¶¶ 419-431.

167 *Tenth Report & Order on Universal Service* at ¶ 426. We noted that "Commission-authorized depreciation lives are not only estimates of the physical lives of assets, but also reflect the impact of technological obsolescence and forecasts of equipment replacement. We believe that this process of combining statistical analysis of historical information with forecasts of equipment generates forward-looking projected lives that are reasonable estimates of economic lives, and therefore, are appropriate measures of depreciation." *Id.* We also found that use of the shorter lives proposed by the incumbent LECs to be used in the universal services support cost model could "potentially trigger a dramatic distortion of the estimated cost of providing the supported services." *Id.* at ¶ 428.

168 Bell Atlantic Comments at 8.

169 See ¶ 29, *supra.*

170 *See* Attachment B setting forth existing and proposed lives in this proceeding.

171 47 U.S.C. § 160(a)(3).

172 Several incumbent LECs have acknowledged the possibility that one or more incumbent LECs could make a takings claim. *See e.g.*, BellSouth Comments at 22; USTA Comments at 6; SBC Comments at 16. Such a claim would likely be based on the contention that the Commission-prescribed lives have been too long and have prevented carriers, in past years, from taking adequate depreciation expense. Because no carrier has asserted a specific takings claim, however, we have no factual situation before us that we can properly analyze on the merits in this proceeding.

in making our public interest analysis, whether forbearance will promote competitive market conditions.[173] We conclude that it does not. Specifically, we find that forbearance would be likely to raise prices for interconnection and UNEs, (particularly those that may constitute bottleneck facilities) inputs competitors must purchase from incumbent LECs in order to provide competitive local exchange service. Because we find that the result of forbearance would be higher costs for competitive LECs which could impair their ability to enter and compete in local markets, we cannot find that forbearance would promote competitive market conditions. USTA has therefore failed to make the showing required by the third prong of the forbearance analysis, that forbearance from our depreciation prescription process is consistent with the public interest.

1. Exogenous Cost Determinations

64. In considering whether to grant forbearance, we must consider whether the carriers' expressed desire to obtain exogenous treatment for alleged past reserve deficiencies, which would translate into higher rates, is consistent with the public interest. The Commission has ruled that exogenous treatment will only be allowed when accounting changes result in "economic cost changes caused by administrative, legislative or judicial requirements beyond the control of the carriers that are not reflected in the (Gross Domestic Product – Price Index) GDP-PI."[174] All parties agree that the Commission has consistently denied exogenous treatment for increases in current depreciation expense that result from a change in depreciation rates.[175] Indeed, if we were to forbear from depreciation requirements, our policy decision concerning exogenous treatment of costs resulting from changes in depreciation rates would likely be consistent with our previous decisions. Such a determination is further based on the significant impact that such increases will have on consumer rates. For example, if incumbent LECs adopt the dramatically shorter projection lives that they are advocating, they could immediately show over $34 billion in apparent depreciation reserve deficiencies.[176]

65. Several incumbent LECs, however, have expressly reserved a right to claim exogenous treatment of past reserve deficiencies.[177] These carriers argue that reserve deficiencies resulted from the Commission's prescription of unrealistically long lives, thereby causing the LECs' plant to be under-depreciated.[178] First, we do not agree that the incumbent LECs' plant is

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[173] 47 U.S.C. § 160(b).

[174] Price Cap Performance Review for Local Exchange Carriers, *First Report and Order*, 10 FCC Rcd 8961, 9090 (1995). GDP-PI is an acronym for "Gross Domestic Product – Price Index."

[175] Ameritech Comments at 8; Bell Atlantic Comments at 9; BellSouth Comments at 18-19; Cincinnati Bell Comments at 5; GSA Reply at 6; Sprint Comments at 15; US West Comments at 8.

[176] US West Comments at 11, *citing* Arthur Andersen, LLP's Supplement to its Position Paper on Accounting Simplification in the Telecommunications Industry at 17, CC Docket Nos. 98-91 (filed Nov. 10, 1998) (states that Regional Bell Operating Companies and GTE show a $34 billion difference between their depreciation on their financial books and the depreciation on their regulatory books); Ameritech Comments at 14. *See also* Ad Hoc Comments at 8 (states that USTA estimated that a $17.9 billion reserve deficiency would be created by adopting shorter projection lives without making any other changes, such as adopting accelerated depreciation, to the Commission's depreciation procedures).

[177] No incumbent LEC has stated that it will not make such claims in the future. Several incumbent LECs state that forbearance would prevent them from recovering reserve deficiencies that arose in the future but are silent about whether they believe they could recover past reserve deficiencies. Ameritech Comments at 9; BellSouth Comments at 23. *See also*, Ad Hoc Reply at 8-12.

[178] BellSouth Comments at 12; Cincinnati Bell Comments at 8; SBC Comments at 22.

underdepreciated. In fact, their depreciation reserves are at a historic high level of 51 percent of total plant and, under Commission-prescribed projection lives, they are continuing to add over $10 billion per year to their reserves.[179] Second, even if the incumbent LECs had reserve deficiencies, we would not expect them to obtain exogenous treatment under Commission precedent.[180]

66. We believe, however, that if we were to forbear from depreciation prescription, the potential for controversy about the amortization of alleged past reserve deficiencies would persist. We would expect any such proceedings to be contentious and protracted, which could impose significant administrative burdens on both the Commission and the carriers and impose additional delay in resolving depreciation issues. We conclude, therefore that it would not be consistent with the public interest to forbear from depreciation prescription while carriers reserve the right to claim exogenous treatment for past reserve deficiencies.

2. Actual Price Index Higher Than its Price Cap Index

67. The Commission's rules permit a carrier to file rates that would result in an Actual Price Index (API)[181] higher than its Price Cap Index (PCI),[182] provided that it files detailed cost support.[183] Although an above-cap filing is intended to be an extraordinary remedy,[184] it may become increasingly important as we eliminate the low-end adjustment for carriers that qualify for and adopt pricing flexibility.[185] If we were to forbear from depreciation regulation, then carriers could base an above-cap filing on the alleged reserve deficiencies that they would create if they adopted dramatically shorter lives for depreciation. We conclude that it would not be in the public interest to forbear from depreciation prescription as long as incumbent LECs reserve the right to use any alleged past reserve deficiencies to support price increases they could request in an above-cap filing. Forbearance before such claims are resolved is likely to lead to contentious and protracted proceedings about the appropriateness of the depreciation expense used to support a carrier's above-cap filing. The carriers contend that after forbearing from depreciation prescription, we could evaluate the appropriateness of a carrier's depreciation

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179 MCI-WorldCom Reply, Attachment 1 at 4.

180 *LEC Price Cap Order*, 5 FCC Rcd at 6809. "[C]ost changes due to changes in depreciation rates are endogenous .... [The Commission's] prescription of depreciation rates is not a reason for declaring these rates exogenous, because the decision of when to deploy or retire equipment is controlled by the carrier."

181 This is the "price" in "price cap." It is the Actual Price Index and is a calculated weighted average of prices for all services that are subject to price caps. *See* 47 C.F.R. § 61.45.

182 This is the "cap" in "price cap." It is the Price Cap Index that normally establishes the upper limit above which a carrier cannot raise its API. *See* 47 C.F.R. § 61.46.

183 47 C.F.R. § 61.49(e).

184 Policy and Rules Concerning Rates for Dominant Carriers, *Second Report and Order*, 5 FCC Rcd 6786, 6823 (1990). In adopting the price cap rules, the Commission stated that, when above-cap rates are filed, a different and higher review standard will be applied than when the rates filed are within the cap.

185 Access Charge Reform, *Fifth Report and Order and Further Notice of Proposed Rulemaking*, CC Docket No. 96-262, FCC 99-206 (rel. Aug. 27, 1999).

expense each time it makes an above-cap filing.[186] We reject such an approach for the same reasons we rejected it in connection with the low-end adjustment.[187]

3. Interconnection and Unbundled Network Elements (UNEs)

68. Section 10(b) of the Act requires us, as part of our public interest determination, to "consider whether forbearance from enforcing the provision or regulation will promote competitive market conditions, including the extent to which forbearance will enhance competition among providers of telecommunications services."[188] We find that forbearance would not enhance but, rather, would likely retard competition. Because the primary purpose of requiring incumbent LECs to provide interconnection and unbundled network elements is to stimulate competition in the provision of local exchange service,[189] allowing ILECs to increase rates for those services by significantly increasing depreciation expense could adversely affect competition by raising input prices that competitors pay.

69. Incumbent LECs contend that, because prices for interconnection and UNEs are based on forward-looking costs, they should not be affected by changes in the Commission's depreciation prescription process. We find however, that forbearance could affect rates for these services. In the *Local Competition Proceeding*, the Commission required the use of "economic depreciation" in calculating rates for interconnection and UNEs, but it did not elaborate on how economic depreciation should be calculated.[190] Based on our review to date, twenty-four states commissions have required incumbent LECs to use FCC-prescribed projection lives and salvage factors, or similar state-prescribed factors, to calculate their rates for UNEs.[191] We are concerned that forbearance from depreciation regulation by the Commission might deprive state regulatory commissions of valuable information that they may want or need in setting rates for interconnection and UNEs,[192] and might enable incumbent LECs to raise arbitrarily the rates for essential inputs that competitors must purchase from the incumbent LECs. This could have an adverse impact on the development of local competition.

70. Conversely, the incumbent LECs contend that the Commission's depreciation prescription process hampers competition by preventing incumbent LECs from competing effectively in an increasingly competitive environment. They state that failure to lift regulatory restrictions on depreciation can only distort efficient technology choices by incumbent LECs.[193]

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186 US West Comments at 8. *See also* Ameritech Comments at 8; Cincinnati Bell Comments at 4. BellSouth Comments at 22; Bell Atlantic Comments at 7; USTA Comments, Attachment A at 18.

187 *See* ¶ 50, *supra*. *See also* MCI-WorldCom Comments at 6; GSA Reply at 9.

188 47 U.S.C. § 160(b).

189 47 U.S.C. § 251.

190 Implementing the Local Competition Provisions in the Telecommunications Act of 1996, *First Report and Order*, 11 FCC Rcd 15499, at ¶703 (1996).

191 *See* n. 97, *supra*.

192 The Commission's pricing rules for interconnection and UNEs had been vacated by the Eighth Circuit Court of Appeals *Iowa Utilities Board v. FCC*, 120 F. 3d 753, 800, 804, 805-806 (8th Cir. 1997). The Supreme Court reversed the Circuit Court decision and reinstated the Commission's jurisdiction to specify pricing rules that the state commissions must follow in setting prices for interconnection and unbundled network elements. *AT&T Corp. v. Iowa Utilities Board*, 119 S.Ct. 721 (1999).

193 USTA Comments, Attachment A at 8.

Essentially, the incumbent LECs are contending that the Commission prescribed depreciation rates are too low to allow them to make needed investments. Unreasonably low depreciation rates could deter a carrier from making needed plant investments, if the carrier could not generate sufficient funds either through internal[194] or external sources[195] to finance these investments. For the incumbent LECs for which we prescribe depreciation rates, however, this is not the case. For example, since 1994 their internally generated funds alone have exceeded their plant investments by nearly 50 percent.[196] Furthermore, there is little question that these firms could acquire additional capital from external sources if they needed such funds for network upgrades.[197]

71. Consequently, we conclude that, with respect to interconnection and UNEs, forbearance from depreciation prescription is not in the public interest because it is likely to have an adverse effect on competition by raising the input prices that competitors must pay to provide local exchange service. We therefore conclude that USTA has not satisfied the third prong of the section 10 forbearance standard.

72. We therefore find that none of the three prongs of the section 10 forbearance test is met. We thus deny USTA's petition for forbearance from the prescription of depreciation prescription.

V. PROCEDURAL ISSUES

A. Final Regulatory Flexibility Act Certification

73. In the *Depreciation Notice*, we certified that the Regulatory Flexibility Act did not apply to this rulemaking proceeding because none of the proposed changes to our depreciation prescription process would have a significant economic impact on a substantial number of small entities.[198] Pursuant to longstanding rules, the proposed changes would apply only to incumbent LECs with annual operating revenues exceeding the indexed revenue threshold.[199] No comments were received concerning the proposed certification.

74. The Regulatory Flexibility Act defines a "small business" to be the same as a "small business concern" under the Small Business Act.[200] Under the Small Business Act, a

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194 Ad Hoc Reply at 4. Internally generated funds represent the difference between a firm's operating revenues and cash expenses. Because incumbent LECs are capital intensive, depreciation expense is a large component of their internally generated funds.

195 Sources of externally generated funds are new issuances of debt and equity.

196 *See* ARMIS Report 43-02, Tables B-1 and B-2.

197 For example, as of December 31, 1998, Ameritech has available $1.2 billion in unsecured debt securities (*see* Ameritech's 1998 Annual Report, Note 6 to Consolidated Financial Statements); Bell Atlantic has in excess of $4.5 billion of unused lines of credit (*see* Bell Atlantic's 1998 Annual Report, Note 8 to Consolidated Financial Statements); and SBC has unused lines of credit totaling $1.5 billion (*see* SBC's 1998 Annual Report, Note 10 to Consolidated Financial Statements).

198 *See* 5 U.S.C. § 605(b); *Depreciation Notice*, 13 FCC Rcd at 20555.

199 The revenue threshold was adjusted by an index for inflation and was set at $112 million for 1996. *See* Implementation of the Telecommunications Act of 1996: Reform of Filing Requirements and Carrier Classifications, *Order and Notice of Proposed Rulemaking*, 11 FCC Rcd 11716, 11745-47 (1996); Public Notice, Annual Adjustment of Revenue Threshold, 14 FCC Rcd 6911 (1999).

200 *Id.* at § 601(6), adopting 15 U.S.C. § 632(a)(1).

"small business concern" is one that: (1) is independently owned and operated; (2) is not dominant in its field of operation; and (3) meets any additional criteria established by the Small Business Administration.[201] Section 121.201 of the Small Business Administration regulations defines a small telecommunications entity in SIC code 4813 (Telephone Companies Except Radio Telephone) as any entity with 1,500 or fewer employees at the holding company level.[202] Entities directly subject to these rule changes are carriers subject to price cap regulation.[203] These entities are generally large corporations that have more than 1,500 employees, or they are either dominant in their fields of operations or are not independently owned or operated. Thus, they are not "small entities" as defined by the Small Business Act.[204]

75. We therefore certify that the changes to our depreciation prescription procedures adopted herein will not have a significant economic impact on a substantial number of small entities.[205] The Commission shall provide a copy of this certification to the Chief Counsel for Advocacy of the Small Business Administration, and include it in the report to Congress pursuant to the SBREFA.[206] The certification will also be published in the Federal Register.[207]

B. Final Paperwork Reduction Act Analysis.

76. The decision herein has been analyzed with respect to the Paperwork Reduction Act of 1995, Pub. L. 104-13, and has been approved in accordance with the provisions of that Act. The Office of Management and Budget (OMB) approved the requirements under OMB control number 3060-0168, which expires December 31, 2001.

VI. ORDERING CLAUSES

77. Accordingly, IT IS ORDERED that, pursuant to Sections 1,2,4, 11, 201-205, and 218-220 of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 152, 154, 161, 201-205, and 218-220, Part 43 of the Commission's rules, 47 C.F.R. Parts 43, is AMENDED, as shown in Appendix C below.

78. IT IS FURTHER ORDERED that, pursuant to Sections 1-4, 201-205, 220 and 303(r) of the Communications Act of 1934, as amended, 47 U.S.C. §§ 151-154, 201-205, 220 and 303(r) that the REPORT AND ORDER IS ADOPTED, effective 60 days after publication of a summary in the Federal Register. The collections of information contained within are contingent upon approval by the Office of Management and Budget.

79. IT IS FURTHER ORDERED that, pursuant to Sections 1, 4, 10, and 220 of the

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201 15 U.S.C. § 632. *See, e.g., Brown Transport Truckload, Inc. v. Southern Wipers, Inc.*, 176 B.R. 82 (N.D. Ga. 1994).

202 13 C.F.R. § 121.201.

203 Aliant, Ameritech, Bell Atlantic, BellSouth, Cincinnati Bell, Citizens, GTE, Nevada Bell, NYNEX (Bell Atlantic North), Pacific Bell, Southern New England Telephone, Southwestern Bell, Sprint, and US West each filed price cap tariffs with the Commission in 1997.

204 15 U.S.C. § 632(a)(1).

205 5 U.S.C. § 605(b).

206 5 U.S.C. § 801(a)(1)(A).

207 5 U.S.C. § 605(b).

Communications Act of 1934, as amended, 47 U.S.C. §§ 151, 154, 160, and 220 that the Petition for Forbearance from Depreciation Regulation of Price Cap Local Exchange Carriers filed by the United States Telephone Association is hereby DENIED.

80. IT IS FURTHER ORDERED that the Reference Information Center, Consumer Information Bureau, shall send a copy of this Report and Order, including the Initial Regulatory Flexibility Analysis, to the Chief Counsel for Advocacy of the Small Business Administration.[208]

FEDERAL COMMUNICATIONS COMMISSION

Magalie Roman Salas
Secretary

[208] 5 U.S.C. § 605(b).

APPENDIX A

Parties Filing Comments and Reply Comments
(in CC Docket No. 98-81 and ASD File No. 98-64)

Parties Filing Comments

Ad Hoc Telecommunications
Ameritech
AT&T Corporation
Bell Atlantic
BellSouth
Cincinnati Bell Telephone Company
Con-Ex Corporation
General Services Administration
GTE Services Corporation
MCI-WorldCom, Inc.
New Networks Institute
Public Service Commission, State of Florida
Sprint Corporation
Southwestern Bell Telephone Company
United States Telephone Association
US West, Inc.
Virginia State Corporation Commission Staff

Parties Filing Reply Comments

Ad Hoc Telecommunications
Ameritech
AT&T Corporation
Bell Atlantic
BellSouth
Cincinnati Bell Telephone Company
General Services Administration
MCI-WorldCom, Inc.
Southwestern Bell Telephone Company
United States Telephone Association
US West, Inc.

APPENDIX B

Summary of Current Prescription Life Ranges and Proposals (In Years)

	FCC Prescribed	SBC Proposal	TFI Proposal	BellSouth Proposal
Fiber Cable – All Categories	25 –30	20	20	
Underground Cable - Metallic	25 – 30	12.5 - 15.5	14 - 20	10 - 14
Buried Cable – Metallic	20 – 26	18 -19	14 - 20	12 - 16
Aerial Cable – Metallic	20 –26	13.5 - 16	14 - 20	12 - 16
Circuit Equipment – Digital	11 – 13	7 - 13	6 - 9	8 - 10
Switching – Digital	12 –18	7 - 16	9 - 12	8 - 10

APPENDIX C -- FINAL RULES

Part 43 of Title 47 of the C.F.R. is amended as follows:

PART 43 – REPORTS OF COMMUNICATIONS COMMON CARRIERS AND CERTAIN AFFILIATES

1. The authority citation for Part 43 continues to read as follows:

Authority: 47 U.S.C. 154: Telecommunications Act 0f 1996, Pub. L. 104-104, §§ 402 (b)(2)(B), (c), 110 Stat. 56 (1996) as amended unless otherwise noted. 47 U.S.C. 211, 219, 220 as amended.

* * * * *

2. New Section 43.43 (c)(2) would be added and old section (c)(2) would be renumbered as (c)(3) to read as follows:

* * * * *

(c)(2) Local Exchange Carriers that are regulated under price caps, pursuant to §§ 61.41 through 61.49 of this chapter, and have selected basic factors that fall within the basic factor ranges for all accounts are exempt from b(3), b(4), and (c) introductory text. They shall instead comply with b(1), (2) and (5) and provide a book and theoretical reserve summary and a summary of basic factors underlying proposed rates by account.

(c)(3) Interexchange carriers regulated under price caps, pursuant to §§ 61.41 through 61.49 of this chapter, are exempted from submitting the supplemental information as described in paragraph (c) introductory text. They shall instead submit: Generation data, a summary of basic factors underlying proposed depreciation rates by account and a short narrative supporting those basic factors, including: Company plans of forecasted retirements and additions; and recent annual retirements, salvage and cost of removal.

* * * * *

3. Section 43.43 (e) would be revised to read as follows:

(e) Unless otherwise directed or approved by the Commission, the following shall be observed: Proposed changes in depreciation rates shall be filed at least ninety (90) days prior to the last day of the month with respect to which the revised rates are first to be applied in the accounts (e.g., if the new rates are to be first applied in the depreciation accounts for September, they must be filed on or before July1); and such rates may be made retroactive to a date not prior to the beginning of the year in which the filing is made: *Provided, however,* That in no event shall a carrier for which the Commission has prescribed depreciation rates make any changes in such rates unless the changes are prescribed by the Commission. Carriers who select basic factors that fall within the basic factor ranges for all accounts are exempt from depreciation rate prescription by the Commission.

* * * * *

DISSENTING STATEMENT OF COMMISSIONER FURCHTGOTT-ROTH

Re: *1998 Biennial Regulatory Review – Review of Depreciation Requirements for Incumbent Local Exchange Carriers, United States Telephone Association's Petition for Forbearance from Depreciation Regulation of Price Cap Local Exchange Carriers*, Report and Order in CC Docket 98-137, Memorandum Opinion and Order in ASD 98-91.

I find it encouraging that the Commission has streamlined some of the costly and burdensome depreciation prescription requirements that are currently imposed on the large incumbent local exchange carriers. I would have gone a good deal further, however. Because I believe that the Commission's depreciation requirements no longer serve a useful purpose, and because I believe that the requirements of section 10 have been satisfied, I would have granted USTA's petition for regulatory forbearance.

Background. Depreciation expenses were at one time a significant part of the regulatory equation. Under rate-of-return regulation, which the Commission abandoned for large carriers in 1990, a carrier's interexchange access prices were calculated based on its costs, including its depreciation expenses. Although I certainly do not endorse rate-of-return price regulation, I accept the proposition that if an agency employs that approach, it needs to monitor the costs of the companies it regulates.

The Commission no longer sets prices for large local exchange carriers' services based on costs. Beginning in 1990, it adopted the fundamentally different price-cap methodology, which directly governs a carrier's access charges, and the carrier retains whatever profit it is able to make. From 1990-1997, the Commission took something of a hybrid approach to rate regulation, since carriers were required to "share" all or some portion of their earnings over a specified rate of return. In addition, the Commission's methodology included a "low-end adjustment" mechanism, which guaranteed that a local exchange carrier would not be forced to charge unreasonably low prices. Again, although I do not endorse either the "sharing" or "low-end adjustment" mechanisms –indeed, they are nonsensical from an economic standpoint, since they both limit the efficiency gains of price-cap regulation – I understand that depreciation expenses were relevant to this hybrid regulatory approach.

In 1997, however, the Commission eliminated the "sharing" mechanism altogether, finding that it blunted the efficiency incentives of price-cap regulation. At this point, with respect to rate regulation, carriers' depreciation expenses continued to be relevant only to the "low-end adjustment" mechanism.

Today's Order. The Commission today offers up a flimsy set of justifications for its continued imposition of depreciation requirements on incumbent carriers. None withstand scrutiny.

The only rationale put forth by the Commission that makes any sense at all is that depreciation prescription continues to be necessary in order to determine when a carrier is entitled to the low-end adjustment. But I do not think the low-end adjustment is an essential component of price-cap regulation, and I would support eliminating it entirely. Without the low-end adjustment, there would no longer be any legitimate reason for continuing to regulate incumbent carriers' depreciation expenses.

The Commission has traditionally reasoned that the "low-end adjustment" is necessary to avoid unconstitutional takings problems. I do not think this theory is a sufficient basis for retaining the low-end adjustment, particularly since it means retaining the Commission's burdensome and costly depreciation requirements. To prevail on such a claim, carriers would have to make the very difficult showing that the Commission's price-cap requirements had threatened their "financial integrity" or "otherwise impeded[d] their ability to attract capital," *Illinois Bell Tel. Co. v. FCC*, 988 F.2d 1254, 1263 (D.C. Cir. 1993). In any event, the carriers themselves have indicated that they are ready to give up the low-end adjustment as part of a regulatory adaptation to increased competition. *See* Taylor & Bannerjee Affidavit at 13 (submitted on behalf of USTA) (Nov. 23, 1998).

Even if the Commission continues to think it necessary to guard against the possibility of a regulatory taking, I think that there are other, less burdensome ways to accomplish this objective. For example, as BellSouth has suggested, the Commission could make the availability of the "low-end adjustment" contingent on a showing that a carrier's depreciation expenses were proper. *See* Order ¶ 46. The Commission dismisses this proposal on the ground that it would leave the Commission with "little or no basis on which to evaluate the reasonableness of the incumbent LECs' claimed depreciation expense." *Id.* This reasoning is disingenuous - there are many sources apart from its own depreciation requirements that the Commission could use to assess the reasonableness of a depreciation expense. The Commission also says that BellSouth's proposal is "limited to the current price cap plan," stating that "any major change in that plan could reinstate the need for a low-end adjustment." *Id.* But BellSouth has not proposed eliminating the "low-end adjustment" entirely. The adjustment would simply be made available upon a showing that a carrier is entitled to that adjustment. Why would the possibility that the price-cap plan might change make this proposal unworkable?

The Commission also justifies its refusal to forbear from depreciation regulation on the ground that, if carriers were allowed to set their own depreciation expenses, incumbent carriers might request exogenous treatment of past reserve deficiencies, or make above-cap filings based on past reserve deficiencies. In the first place, I think it extremely unlikely that incumbent carriers could succeed on either of these theories. The Commission has consistently refused to permit carriers to treat changes in depreciation expenses as exogenous costs, and there is no basis for thinking that policy is unsound. Nor is there any reason to think that carriers could make the showing that they are entitled to the "extraordinary remedy" of an above-cap filing.

More important, however, I do not think that the possibility that, if the depreciation requirements were lifted, carriers might take positions adverse to the Commission is any basis for declining to forbear from depreciation regulation. What the Commission seems to be saying is that, if lifting its regulations would somehow enable carriers to challenge the effects that those requirements have had, it must continue to impose those requirements – whether or not the regulations continue to serve any other, useful purpose. This reasoning is quite simply indefensible. An administrative agency has a fundamental obligation to engage in reasoned decisionmaking, which in turn means that the agency must be prepared to explain and defend its regulations. If carriers can legitimately claim that the Commission's past requirements would support a low-end adjustment or an above-cap filing, it is in the public interest for the Commission fairly to address those claims. It is most certainly *not* in the public interest for the Commission to continue to impose meaningless requirements on incumbent carriers simply because it is afraid it might have to defend those regulations.

Nor do I believe the other reasons the Commission has raised for refusing to forbear from its depreciation regulation withstand scrutiny. The Commission contends that State commissions have used Commission-prescribed depreciation rates in setting prices for interconnection and unbundled network elements, and forbearance would deprive State commissions of this information. I question whether it is appropriate to continue to require incumbent carriers to comply with burdensome federal depreciation regulations simply to provide State commissions with information that they could themselves gather from many other sources. Nor do I agree with the Commission that its requirements are necessary for it to determine which depreciation inputs it should use in the universal service high-cost support model. To the extent such inputs are needed for what has always been described as a "forward-looking" model, the Commission could easily come up with many simpler ways of setting the values of those inputs.

Conclusion. In my opinion, there is no valid reason for continuing to require the large incumbent local exchange carriers to comply with the Commission's burdensome and anachronistic depreciation regulations. In light of this conclusion, I believe that USTA's forbearance petition should have been granted, and I do not believe the Commission possesses the authority to require carriers to comply with the waiver conditions that it has devised.